Merit Medical Systems, Inc (4Q 2021 Earnings)

February 24, 2022

Corporate Speakers:

- Fred Lampropoulos; Merit Medical Systems, Inc.; Founder, Chairman, CEO & President
- Brian Lloyd; Merit Medical Systems, Inc.; Chief Legal Officer & Corporate Secretary
- Raul Parra; Merit Medical Systems, Inc.; CFO & Treasurer

Participants:

- Unidentified Participant; Piper Sandler; Analyst
- Larry Biegelsen; Wells Fargo Securities, LLC; Senior Medical Device Equity Research Analyst
- Mike Matson; Needham & Company, LLC; Senior Analyst
- Jayson Bedford; Raymond James & Associates, Inc.; Senior Medical Supplies and Devices Analyst
- Jim Sidoti; Sidoti & Company, LLC; Research Analyst
- Bill Plovanic; Canaccord Genuity Corp.; Analyst
- Steve Lichtman; Oppenheimer & Co. Inc.; MD & Senior Analyst

PRESENTATION

Operator: Good afternoon, ladies and gentlemen, and welcome to the Fourth Quarter and Fiscal Year 2021 Earnings Conference Call for Merit Medical Systems, Inc. (Operator Instructions) Please that this 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 Lampropoulos: Thank you, and welcome, everyone, to Merit Medical's fourth quarter and fiscal year '21 earnings conference call. I'm joined today on the call by Raul Parra, our Chief Financial Officer and Treasurer; and Brian Lloyd, our Chief Legal Officer and Corporate Secretary. Brian, would you please take us through the safe harbor statements.

Brian Lloyd: Thanks, Fred. Before we start, 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 as of today, February 24, 2022 only, 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. 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 our 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 Lampropoulos: 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 better-than-expected revenue and financial results for the fourth quarter and 2021 fiscal year. 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 2022 that we introduced in this afternoon's press release, as well as a summary of our balance sheet and financial condition. We will then open the call for your questions.

Beginning with a review of our fourth quarter revenue performance, we reported total GAAP revenue of $278.5 million in the fourth quarter, up 7.9% year-over-year. Our total GAAP revenue growth was driven by 6.4% growth in U.S. sales and a 10% growth in international sales. Excluding the headwind to our GAAP revenue growth as a result of changes in exchange rate compared to the prior year period, our total revenue increased 8.4% year-over-year in the fourth quarter on an organic constant currency basis. Our total constant currency growth was primarily driven by a 6.6% increase in U.S. sales and a 10.8% increase in international sales.

Our fourth quarter revenue exceeded the updated guidance we discussed in our Q3 call and implied fourth quarter constant currency revenue would increase in the range of

approximately 2% to 6% year-over-year. The strong revenue results in quarter 4 were driven by solid execution from our team, stronger-than-anticipated demand from OEM customers and more favorable sales trends in China versus what our updated guidance range had assumed.

Turning to a more detailed review of our revenue results in quarter 4. Note unless otherwise stated, all growth rates are on a year-over-year and constant currency basis. In terms of our sales performance by our primary reportable product categories, fourth quarter total revenue growth was driven primarily by 9% growth in sales of cardiovascular products and 4% growth in sales of endoscopy products compared to the prior year period. Sales of our peripheral interventional products increased by 11% year-over-year, representing approximately half of the total Cardiovascular segment growth year-over-year. Sales of our drainage and envelope therapy products, which together represented roughly 1/3 of our total PI business increased 9% year-over-year in Q4 and together with the largest contributor to total PI growth in the quarter.

Sales of our Scout radar localization products increased 14% year-over-year in quarter 4, and sales of our biopsy products increased 23% year-over-year in the fourth quarter. Sales of our cardiac intervention products increased 12% year-over-year, representing the second largest contributor to total Cardiovascular segment growth year-over-year. Sales of our intervention products were the largest drivers of the CI product growth category increasing 12% year-over-year, fueled by growth of our Basix and MAP lines, which increased 18% and 16% respectively in quarter 4.

Sales of our angiography products also contributed meaningfully to our total CI product category growth, increasing 18% year-over-year in quarter 4, driven by continued strong demand for our diagnostic guidewires and cardiology diagnostic catheters. Sales of our OEM products was much stronger than expected in Q4, increasing 16% year-over-year, driven by improving demand from large customers replenishing inventory levels in multiple categories, including kits, EP, CRM and fluid management products.

Our total cardiovascular sales growth was offset partially by a 5% decrease year-over-year in sales of our CPS products. However, the stable demand trends in this area of our cardiovascular business was masked by a $4 million net headwind from the sale of the Cultura year-over-year sales. Prior year sales also included $2.5 million of sales from our ITL business, which did not contribute to sales in the fourth quarter of 2021, given the divestiture. Excluding Cultura and ITL, sales of our CPS product category increased 4% -- excuse me, 8% in quarter 4. Finally, sales in our Endoscopy segment increased 4% in quarter 4, driven primarily by a 27% increase in sales of our EndoMAXX line as we remedied the supply chain interruption that impacted sales in the fourth quarter of 2021.

Now turning to a brief summary of sales performance on a geographic basis. As I mentioned, our fourth quarter sales in the U.S. increased 6.6% year-over-year and our international sales increased 10.8% year-over-year, both on a constant currency basis. Sales to U.S. customers represented 45% of our total growth in quarter 4, led by our U.S. direct business, which increased approximately mid-single digits year-over-year. Elective

procedures were steady during quarter 4 until COVID cases -- case counts began to surge during the back half of December as the Omicron variant took hold in the U.S. At that time, numerous hospital systems began announcing moratoriums on nonurgent procedures that could require an overnight stay, in some cases, for up to 30 days.

Directly related and according to data from the Department of Health and Human Services, Utah, excuse me, U.S. hospitals were reporting critical staffing shortages, the most since late December of 2020. Additionally, tighter restrictions on sales and clinical access in large part mirrored the surge in case counts and hospitalizations during December.

Sales in the 3 global regions, APAC, EMEA and Rest of the World increased approximately 7%, 14% and 14%, respectively on a constant currency in the fourth quarter. Similar to the OUS trends, we have discussed on earnings calls throughout 2021, we continue to see notable variation in the pace of recovery across regions of the world where we do business, including wide variation within certain geographic regions. The EMA region was choppy in quarter 4 as the region continued to see material impacts from COVID-19, specifically in terms of access restrictions, which depending on the country, were limited as much as 60% to 70%. That said, elective procedures continue to ramp back up, although we are not back to pre-COVID levels.

We are managing our EMEA business well overall and are leveraging virtual selling strategies as much as possible, which is helping us to drive the business forward despite the challenging operating environment. The EMEA region was the largest contributor to total international revenue growth in quarter 4, with the strongest sales results of the EMEA business coming from Russia, United Kingdom, other EMEA, Italy and France.

APAC sales increased 7% in quarter 4. Although excluding the impact of the divestiture of the ITL business, sales increased 12% year-over-year. Sales in China increased 13% year-over-year in the fourth quarter. As mentioned earlier, these results were far better than we contemplated in our quarter 3 call, when we foresaw flattish sales year-over-year. The better-than-expected sales results in China in the fourth quarter was driven by demand for our inflation devices in advance of the volume-based purchasing tenders that we currently expect to begin in April of this year. In summary, we are proud that we're able to deliver results above the high-end of our guidance range despite the tougher-than-anticipated operating environment in quarter 4.

Now before turning the call over to Raul, I wanted to comment on a few other noteworthy items in the quarter. First, we delivered another quarter of impressive profitability improvement, margin expansion and free cash flow generation in quarter 4. Our non-GAAP gross profit and our non-GAAP net income reflects strong leverage in the period, increasing 13% and 33% respectively, compared to the prior year. Our non-GAAP gross margin increased 210 basis points year-over-year to 50%, a record for us, and we managed our expenses prudently, which resulted in a non-GAAP operating margin of 17.4%, also a record for us. We also generated more than $37 million worth of free cash flow in the quarter.

Finally, I wanted to provide a brief update on our Foundations for Growth Program. Specifically, we've made considerable progress in year 1 of the program, and we believe our efforts to date have added a transformative impact on our company. We have launched more than 40 initiatives intended to drive value creation for Merit shareholders across many areas, including SKU optimization, network consolidation, compensation and benefits and, of course, product line transfers and manufacturing initiatives we have discussed on prior calls.

The FFG program is helping to offset the inflationary cost pressures we're seeing in certain raw materials and in shipping and freight expenses. Our focus on scrap reduction across manufacturing sites has resulted in more than a 20% reduction in scrap as a percent of our total production. We are also seeing the early benefits of improving our manufacturing efficiency, specific in the area of SKU rationalization, we identified more than 2,000 products that were targeted for obsolescence given low revenue and/or low product gross margins. We have already inactivated 95% of these products with customers. In nearly all cases, we've been able to move them to alternative products.

The Foundations for Growth Program has also formed 6 new teams, including control tower, pricing, global procurement, global HR, EEM Strategic account management and an EMA inside sales team. We've also defined and recruited more than 15 new roles, including a Chief Human Resource Officer, Chief Strategy and Innovation Officer, Vice President of Global Pricing, Vice President of Global Communications and Vice President of Global Head of Talent, and Vice President of Global Comp and Benefits.

Overall, we continue to execute on our FFG's initiatives and are excited about the progress in year 1 and the results we are seeing -- we're seeing across our entire business. Finally, we believe our financial results in fiscal 2021 represent clear evidence that we are making progress towards our goal of enhancing Merit's long-term growth and profitability profile. We increased our constant currency revenue more than 10% year-over-year. We expanded our non-GAAP gross margin 220 basis points year-on-year despite considerable headwinds in our cost of goods line compared to last year. We increased our non-GAAP operating margin 230 basis points year-over-year. And most importantly, we have generated more than $119 million of free cash flow in fiscal year 2021.

We remain committed to financial targets we outlined in the Foundations for Growth Program for the 3-year period ending December 31, 2023, which call 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 free cash flow generating more than $300 million.

Now with that said, let me turn the time over to Raul who will take you through a more detailed review of our fourth quarter financial results and our 2022 financial guidance, which we introduced in the press release this afternoon. Raul?

Raul Parra: Thank you, Fred. Given Fred's detailed review 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 fourth quarter of fiscal year 2021. 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 fourth quarter. Our gross margin for the fourth quarter was 50% compared to 47.9% in the prior year period. The approximate 210 basis point increase in gross margin year-over-year was primarily due to changes in product mix, improvements in manufacturing efficiencies on higher volume, offset partially by inflationary headwinds we are seeing in logistics, labor, and to a lesser extent, in raw materials. Specifically, we estimate the year-over-year increase in logistics and labor expense has represented a headwind to our non-GAAP gross margins of more than 300 basis points in the fourth quarter.

Fourth quarter operating expenses increased 9% compared to the fourth quarter of 2020. The year-over-year increase was driven by a 28% increase in R&D expense and a 5% increase in SG&A expense compared to the prior year period. The increase in R&D expense in Q4 was driven by the combination of the lower spend in the prior year period related to COVID-19. Outside expense for certain R&D projects, in particular, related to Rhapsody clinical study and increased compensation expense related to our acquisition of KA Medical and 2 other new projects.

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, mitigated by our continued focus on managing expenses, which provided effective -- proved effective again this quarter as we were able to reduce G&A only expenses, 4% year-over-year.

Total operating income in the fourth quarter increased $8 million or 19% year-over-year to $48.4 million. Our operating margin for Q4 was 17.4% compared to 15.7% in the prior year period. Fourth quarter other expense net was $1.6 million compared to $2.6 million last year. The change in other expense net was driven by lower interest expense as a result of a lower effective interest rate and lower average debt balance. Fourth quarter net income was $40.8 million or $0.71 per share compared to $30.8 million or $0.54 per share in the prior year period. We are very pleased with our profitability performance in the fourth quarter, where we reported growth in net income and diluted earnings per share of 33% and 31% respectively year-over-year.

Turning to a review of our balance sheet and financial condition as of December 31, 2021. Our strong profitability performance in the fourth quarter of 2021, combined with strong working capital efficiency resulting in a strong free cash flow generation of $37.5 million in the fourth quarter. We generated more than $119 million of free cash flow for the 12 months ended December 31, 2021. We used a portion of this free cash flow to reduce our outstanding borrowings. Specifically, we paid down approximately $108.5

million of debt on our line of credit facility during 2021, including $35.9 million, which we paid down in the fourth quarter.

As of December 31, 2021, we had approximately cash on -- we had cash on hand of $67 million, long-term debt obligations of approximately $243 million and approximately $490 million of available borrowing capacity, compared to cash on hand of $56.9 million, long-term debt obligations of approximately $352 million and available borrowing capacity of approximately $389 million as of December 31, 2020. Our net leverage ratio as of December 31st was 0.9x on an adjusted basis.

Turning to a review of our fiscal year 2022 financial guidance, which we introduced in this afternoon's press release. For the 12 months ended December 31, 2022, the company expects GAAP net revenue growth of approximately 4% to 6% year-over-year. The 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 rates this year. The GAAP net revenue guidance range also assumes net revenue from the Cardiovascular segment growth of approximately 4% to 6%, net revenue from Endoscopy segment growth of approximately 6% to 8% year-over-year.

With respect to profitability guidance for 2022, we 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 assumes 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 margin in the range of approximately 16.6% to 17.3% compared to 16% in fiscal year 2021, non-GAAP other expenses of approximately $6 million, with non-GAAP tax rate of approximately 22%, and diluted shares outstanding of approximately 58 million.

Lastly, given the COVID-related headwinds that impacted our first quarter of 2021, revenue results where sales increased just 2% year-over-year, our guidance assumes growth in the first quarter of 2022 that is modestly higher than the growth ranges over our full year guidance assumes. Specifically, we expect our total revenue to increase approximately [5% to 7%] year-over-year on a GAAP basis and increase of approximately 6% to 8% year-over-year on a constant currency basis in Q1 2022.

Note, our growth expectations for Q1 '22 assume no material improvements in the COVID-related headwinds on the elective procedures we experienced in Q4 '21. We expect our non-GAAP net income and EPS to decline approximately 8% to 16% year-over-year in Q1, driven by inflation-related pressures on our year-over-year gross margin performance and a 10% year-over-year increase in non-GAAP operating expenses against an easier prior year comparison.

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

Fred Lampropoulos: Thank you, Raul. In closing, despite the challenging operating environment in quarter 4, we are proud that we were able to deliver revenue results that exceeded our guidance. We also note that this was a consistent theme in our quarterly results throughout fiscal year 2021. Quarter 4 also represented another quarter of impressive profitability improvement, margin expansion and free cash flow generation, again consistent themes in our quarterly results throughout the fiscal year 2021.

We're confident in our 2022 guidance which calls for total revenue growth on a constant currency basis up 4% to 6% year-over-year, and we expect to see progressive improvement in the 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 operating margins and strong free cash flow in 2022, driven by strong execution and contributions from our multi-year strategic initiatives related to the Foundations for Growth Program.

The benefits from our FFG 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. We are executing well and delivering strong performance despite the challenges. 2021's achievements reflect our team's ability to remain focused on our strategic initiatives, while standing ready to adapt quickly to changes in our markets.

We would like to thank all of you and all of our team members around the world who made this possible. Now that wraps up our prepared remarks, and we would now like to turn the time back over to our administrator and open up the line for questions.

QUESTIONS AND ANSWERS

Operator: Thank you, sir. (Operator Instructions) And our first question coming from the line of Jason Bednar with Piper Sandler. Your line is open.

Unidentified Participant: Hi, guys. This is [Drew] on for Jason, and thank you for taking the questions and congrats on a nice end to the year here.

Fred Lampropoulos: Thanks, Chris (multiple speakers) I said, Jason anyway, sorry.

Unidentified Participant: Not a problem. I wanted to start off on the guidance a little bit here. Just given the macro environment, we've had some med tech companies willing to quantify the level of headwinds that they're assuming into their guidance, from supply chain inflation I think you've made some comments on FX. So just wondering if that's something you'd be willing to do? And then what is your guidance, assuming as far as when you might return to a more normalized operating environment?

Fred Lampropoulos: I'm going to let Raul answer that, Raul?

Raul Parra: Yes, so, I think we're -- from a -- getting back to normal, I think we've been very consistent in our messaging, right? I think we kind of have all along been just talking about a kind of a choppy recovery to normal for a longer period of time than most, right? No V-shaped recovery. So -- but I think we're obviously well into this. We really think we start to get back to a normalized level, kind of the back half of this year. As far as the inflationary expenses that we see in our 2022 guidance, we expect somewhere around 120 basis points in our gross margin that's impacting the -- basically a headwind for 2022 that's built into our guidance.

Fred Lampropoulos: Does that help you, [Drew].

Unidentified Participant: Yes. That's very helpful. Thank you. And then just your comments on China being better-than-expected. Can you maybe flesh out a little bit how sustainable is that higher-than-expected demand? And what's the right way to think about the incremental gains you might get some new product registrations there and then the offset being the anticipated headwinds from pricing? And can you just remind us on the peripheral side. Are those products already cleared to sell in China? Or is the cadence of new launch activity going to pick up throughout the year? Thank you.

Fred Lampropoulos: Well, yes, we have a kind of a constant effort in terms of new products that get approved, whether they be wires, they be splittable sheets and so on and so forth. So when they get approved and how they get approved is really up to the government and whether it be in the U.S. or in China, it's in many, many ways unpredictable. But last year, we got the SwiftNinja approved and then they have to get on the pricing councils, so to speak. So we just keep moving along with those products, and it's kind of just a constant cadence. We currently expect that -- well, we know that some of this pricing is coming on for the volume pricing in April.

Now all of that being said, as you know, last year we spent a lot of time with much to do about nothing. We talked and people would ask questions about China as it all turned out, it was a nonevent. We do know that these events are coming on, but how they peel in, what the competitors do, supply chain issues, there are so many things that can affect and it's really only for a couple of products. Our strategy has been to move, as we've said in previous calls, to move inward to 30 cities that have over 5 million people and continue to invest and grow in China. Raul, do you want to add anything to that?

Raul Parra: The only thing I would add is that we remain confident in our long-term growth expectations for China. And just -- I mean, we did -- for 2021, we grew at 15% on a constant currency basis. So nothing more to that.

Fred Lampropoulos: Yes, I hope that helps.

Unidentified Participant: It does, thank you.

Operator: And our next question coming from Larry Biegelsen with Wells Fargo. Your line is open.

Larry Biegelsen: Good afternoon, guys. Thanks for taking the questions and congrats on a nice quarter, Fred.

Fred Lampropoulos: Thanks, Larry.

Larry Biegelsen: Hope you are feeling better.

Fred Lampropoulos: I am, yes, a lot better. That was like a couple of months ago, where I come on now.

Larry Biegelsen: I know. I know. Fred, the net debt-to-EBITDA at 0.9x, pretty low for you guys. You've been pretty quiet on the M&A front. Valuations have come down. Could you just kind of update us on your thoughts on kind of M&A? Do you think it'll be more active this year? What are -- where are some of the -- where are your criteria for deals? And I have one follow-up.

Fred Lampropoulos: Yes. Well, first thing I'll say, Larry, is how pleased we are with the free cash flow that we've generated over the last couple of years on our Foundations for Growth plan. I think that valuations are coming down and we're out there looking, and we're in a very, very good position as you pointed out.

But at the same time, I think we showed substantial discipline last year in looking at making sure that we didn't make mistakes. I mean, I -- the real issue and the best way for me to answer the last part of your question is we're committed, as you have seen and as we will continue to show in our Foundations for Growth.

So anything we do is going to have -- to be consistent or exceed those expectations, but we're just not going to do it. So we think this works well. It's got everybody enthused here. We've been able to put a lot of plans in place for our employees and pay for them. So Larry, we're out looking. There are some opportunities. And when they meet the right criteria, then we'll hopefully participate in those. But we are not going to chase and we are not going to depart from our program.

That all being said, you're right. We've never been in a better position. We've been able to pay for all the things in the past. We'll be out of dead here, and this thing will continue. In the meantime, we'll pay down debt, but we're out here looking for the right things that help the strategy, not just anything. Raul?

Raul Parra: Yes, I can't add anything else to that. I think we've been very focused, Larry. And obviously, we're committed to FSG. And I guess that's really what -- when we look at acquisitions and M&A targets, that's the focus, right? It's definitely a discussion point. And it's one of the hurdles that, that target has to kind of overcome.

Fred Lampropoulos: I hope that helps, Larry.

Larry Biegelsen: Very much. And one for Raul. When you talked about the Foundations for Growth targets, you only mentioned Raul, the low end, so like 18% for operating margin. Is that -- was that deliberate? Obviously, there's a range of 18% to 21%. Are you pulling people more to the low end? I didn't hear the gross margin target. Is that because inflation has just made that more challenging? Thanks for taking the questions.

Raul Parra: Yes, well, first, Larry look, I think we've been very consistent in our messaging, right? I think we reaffirmed our FFG goals on the call and we've been very consistent from day 1, right? that we are committed to delivering at least 18% on a non-GAAP operating margin, Larry. And I would say that, that based on what we've done this year, based on the guidance that we have this year, I think people can kind of look at where we're at and feel good about those targets. So -- and we feel confident. I guess I would just say that we've consistently said, look, we've talked a lot about the 18%, the target of 18% to 21%. We're fully aware of that and we're committed to the FFT target.

Fred Lampropoulos: And I'll just reiterate what he said and for everybody here, Larry. We are committed to that 18%. We are committed to the Foundations for Growth. It's working. There's a lot of work to be done and we're going to stay on this track because we think it's the right track to be able to provide an increase shareholder value. So that's where -- Raul, anything finally?

Raul Parra: No. I would just say, look, I think if you look at the performance that we had this last year and you look at our guidance for 2022, I think we'll talk about what '23 brings and how we finish off that year when we get there. But again, we're feeling confident in what we've done and what we're going to do this year. Still a lot of wood to chop too.

Larry Biegelsen: Got it. Thanks so much, guys.

Fred Lampropoulos: You bet. Thank you, Larry. Good to hear from you.

Operator: And our next question coming from the line of Mike Matson with Needham. Your line is open.

Mike Matson: Yes, thanks. So if I heard you correctly on the comments on China and the tenders, I think you said something along the lines of -- you saw more demand for the balloon inflators ahead of the tenders. I mean, it seems a little bit opposite from what we've heard from some of the other companies where they've actually seen people kind of deferring orders because the prices are going to typically go down with the tender. So I just wanted to ask about that.

Fred Lampropoulos: Yes, it's a good question. It was a pent-up demand. We've been there a long time. We're the quality player. We're the market leader. There are all those things that play into this, Mike. We -- as we were talking about this, we thought you might see exactly what you stated and what others have seen. We simply did not. And that's all -- I mean, the numbers...

Raul Parra: Yes, I mean we expected a rider. I mean, we had talked about it and kind of expected what everybody else saw, it just didn't -- just didn't happen.

Fred Lampropoulos: Just didn't happen, which is good for us.

Mike Matson: Okay, so was less of an issue of actually benefiting than just not having a negative impact from that. (multiple speakers) No, no worries. So -- and then the Endoscopy business, it's very small relative to your other categories. Is that -- what's the plan there? I mean, is that something that where you plan to get bigger, maybe acquire things or grow it organically with new products or something that you'll develop internally? Or is that something you can potentially divest? It just seems to be very small, a separate category, I guess. And is there any kind of synergies with that business and the other categories that you're in?

Fred Lampropoulos: Well, okay. So you're correct. It is one of the areas that we're really focusing on for scale. So we've been looking for some time. The other part of it is that we are -- we do our inflation devices. They're larger that are used, but there is something that is in our core business, but it's a unique product and a very successful one for us. And we do have ongoing research and development of new products that are complementary and new areas of stenting (inaudible) in that area, in our [warehouse] and our technology base. So you're right. We need more scale there. In terms of divesting it, we don't see any reason to consider that. We're concentrating on how to build that business.

Mike Matson: Okay, got it. Thank you.

Fred Lampropoulos: Thank you, Mike.

Operator: Our next question coming from the line of Jayson Bedford with Raymond James. Your line is open.

Jayson Bedford: Good afternoon, and thanks for taking the questions and congrats on the progress. You guys showed some nice improvement this year. I have a few questions here. And I don't really want to go down this rather whole. But just with the China tenders, first, I guess, do we know for sure that the tender will occur in April? And then kind of second, can we assume that this is factored into the 4% to 6% constant currency guide?

Raul Parra: Well, I mean, our expectation is that they're going to happen and it is built into our guidance. We expect it to start in April. But again, as you know, it comes and goes, right? I mean, I guess there's just -- it's just not consistent, right? We understand it's coming. We're seeing it happen. You've seen it happen with stents. You've seen it happen with the large joint. You're seeing it -- some of the, I guess, regional trauma tenders are happening. So it's definitely happening. It's just a temp, we're up to -- we're at the mercy of the Chinese government, to be honest with you, and the [provinces] right?

Fred Lampropoulos: And the provinces have their own and they're asking on the price list. That's what we were told. Again, I want to go back to what I said previously and that is, you have to remember the range of products, the fact that we have hemostasis valves and other things that go along with this and that we're the market leader. So -- we've seen these programs, but I think going back to inconsistent, it's not Merit that's inconsistent. It may sound like it. It's just there's information that we get from the field about what they think is going to happen. And we went down, as you said, the rabbit hole, we spent a lot of time last year on nothing at all.

So -- but in terms of the 2022 guidance, it assumes that the China growth will be a material driver of growth that we expect, but it's the whole APAC region. So what we're starting to see is places come back to life. Last year, you recall that it was the slower part of it. So we improved this into that whole area and we're really quite excited about the whole APAC region. So I just want to throw that in as well.

Jayson Bedford: Okay. That's helpful. I apologize if I missed this earlier, but what's left in terms of kind of big lifts tied to the Foundations for Growth Program?

Fred Lampropoulos: Well, listen, these are programs that you -- that start out with 3 years. You implement an (inaudible) take like any program, we made considerable progress. We think it's been transformative. I mean, just look at it last year, what we did with gross margin.

We've launched more than 40 initiatives, SKU optimization, network consolidation, compensation and benefits to make sure we can keep the people we have and incentivize them, in addition to the product lines and manufacturing issues that we've done to Mexico. So it's an ongoing process. There's more transfers. There's more SKU optimization. But like anything, when you start digging a hole, the first part of the dirt is relatively easy, but when you start getting to the other stuff, it's a little bit tougher. And -- but we're just committed to it.

And Jayson, as I think we've talked many times, we're believers. We're importantly. All of our employees are believers because they've all been rewarded or hit their bonuses or hit their goals this year and success breeds success. So we -- we've said it a lot today and we'll continue to say of our commitment to finishing what we said we were going to do. Let me go through it again, 5% to 7%, operating margins of 18% to 21%, and over $300 million in free cash flow over that 3-year period, and that's another important issue. Just to clarify for everybody that it's not a 1-year program, it's a 3-year program. And -- and we're doing everything we can to meet or exceed those goals. Raul?

Raul Parra: Yes, look, I'm going to take advantage and just highlight some of the things that we did in 2021. I mean, we're really proud of our employees and the company for really kind of what we've been able to do. I mean, you're seeing it in our P&L, the FFP program is helping us off some of the inflationary cost price in certain raw material, shipping and freight expense. Our focus on scrap reduction across the manufacturing site has resulted in more than 20% reduction in scrap. We're also seeing some of the early

benefits of improving our manufacturing efficiencies, specifically the SKU rationalization. We got rid of almost 2,000 products, no gross margin or no revenue, and about 95% of those have been inactivated, but in nearly all cases moving to alternative products.

In addition, we've got new programs that we're doing with investments that we made, I'll say from an organizational standpoint. We've got the control tower. We've got pricing. We've got global procurement, global HR, EMEA strategic account.

Fred Lampropoulos: And to come back to the original question. There's a lot of work that needs to be done, but we show -- we've proved to ourselves and I think to our shareholders, to our analysts, everybody that's involved in the company about what it can mean. There's a lot of work to be done. I think the language that Raul uses is there's still a lot of wood to chop. But we'll chop it and we'll get the trees down and chop it up and we'll be ready to go, and we'll continue on this pathway.

Jayson Bedford: Okay. Fair enough. Just last one for me. You mentioned that logistics and labor were, I think a 300 basis point impact and was a very strong gross margin number in the fourth quarter. My guess is that the labor costs are here to stay. But what about the logistics headwinds? When do they -- when do you think they start to abate?

Fred Lampropoulos: Yes, well, if I could really answer that with any accuracy, I think the thing that we've looked, I'll answer it this way. We've never been in a rush to set dates and do things because they're always wrong. We think that they will -- we'll adjust them and adapt them as they start to come along or find other methods, which we've been doing all the time.

So let me just say we have full-time logistic people with a lot of experience here that have worked for other big companies. And I have no idea. We have hopes and that sort of thing. But, I mean, who thought we would be where we were last night and the things that happened, how does that affect, what does it do?

So it's a hard -- I can't give you a date. I'll just say that we're working for it and we're aware it's out there, and we're doing everything we can to be aware of the circumstances and adapt to the marketplace and what's out there all the time, Jason. It's a tough question and -- but that's the best way I can answer is, and that is we don't know. But we'll work to adapt to whatever the conditions are in the best way we can, Raul?

Raul Parra: Yes, specifically around freight, we think we can control some things. One of the things that we've done is we're going to allow our group to build more inventory to allow for additional capacity and time on -- during the shipping lanes. So we've got things that we can control that we're going to try and control to help mitigate some of that expense. But yes, I think Fred hit on mostly...

Fred Lampropoulos: And at the end of the day on that is to meet customer needs and do it better than anybody else, and that's part of our FFG. And we're there to be the best in

the business. And I think we've -- I'm proud of what we accomplished last year -- and the -- you all know about the big mall or big mall has to start, and I think it started. We just have got to finish -- I have 2 more years to go and then we'll start talking about where we go from there. We're already thinking about that now. But I'm just saying we're on it, Jayson, as best as we can be.

Jayson Bedford: Okay, great. Thank you, guys.

Fred Lampropoulos: All right. It's good to hear from you, Jayson. Thank you.

Operator: Our next question coming from the line of Jim Sidoti of Sidoti & Company. Your line is open.

Fred Lampropoulos: Hey, Jim.

Jim Sidoti: Hey, good afternoon. Thanks for taking the questions. You called out Rhapsody is one of the reasons why R&D went up in the quarter. So can you just give us an update on how that trial is going? And should we expect R&D to be around this level in the next few quarters?

Fred Lampropoulos: I would say, generally, yes. We want to spend as much as we can and still be within the parameters that we have dedicated. We've made a lot of progress in the fourth quarter. There were 40 sites that were activated. The pace of enrollment has increased year-to-date, and we're targeting the completement of the trial by the end of 2023. So I think we've made a lot of progress.

It was a little slow to start out with because of sites and clinical people that have to be -- they're not our people, but their people to be able to -- the staff to be able to record the results. But Jim, I think we've made a lot of progress in this and particularly recently. We're starting to see acceleration now.

Jim Sidoti: Okay. And then as far as the expense level, is this about right for the next couple of quarters or?

Raul Parra: Well, I think, we'll know -- I mean, we've called out our guidance. We did get some color around Q1, Jim, and I think we'll leave it at that. In other words, it's in our numbers. Yes, yes.

Jim Sidoti: Got it. And anything you can say about what's going on with Russia right now? I know that, that was an area that you had some growth in 2021. Can you give us a sense on what that -- What's going on there?

Fred Lampropoulos: Yes, so it's really interesting to just watch what's been going on in the market today. But first of all, our business in Russia and Ukraine was not material to our 2021 revenue. And importantly, Russia and Ukraine does not represent a key growth

driver in our plan for 2022. So it's just not an important -- I don't want to say it's not important, but it is not material.

Jim Sidoti: Got it, okay.

Raul Parra: Obviously, watching the developments in the region as things unfold in real time.

Fred Lampropoulos: We're keeping an eye on things. But just not material.

Jim Sidoti: All right. And then the $120 million of free cash flow, its --I mean, another great year there. Would you ever consider a share buyback?

Fred Lampropoulos: Well, listen, it's an interesting question and one we've talked about. But I think we have this debt, interest rates are increasing. We want to pay that off and we want to take a look at opportunities, and we have a very strong balance sheet. So I think we'll -- rather than committing ourselves to we'll do this or do that, is just stay on the program we're on, look for the opportunities that we've discussed on this call today.

We are looking. We were very disciplined last year. We didn't chase anything. We didn't get crazy and we don't intend to. On the other hand, there are a lot of things that start to play into better values, different valuations. And then I think that's the kind of thing that we've been waiting for, and we're seeing opportunities pop up. Go ahead, Raul.

Raul Parra: Yes, look, I think we expect to generate strong free cash flow again in 2022. I think about $75 million is a good target to think about for modeling purposes. It's important to consider that we have some planned investments related to FFG that are going to drive our CapEx to the $55 million to $60 million range for the full year of 2022.

Additionally, our free cash flow guidance assumes kind of an uptick in working capital. And that's really 2 things that I want everybody to kind of think about. We'll have a kind of a higher cash payment related to taxes that we've accounted for. And additionally, one of the key items that we talked about earlier is the continued and proactive investments in our inventory balances as part of our strategy to build the required safety stock just to make sure that we can meet our customer demands and needs.

I think our supply chain has been a big factor for us and its vertical integration has really helped us out, and we want to make sure that we have the right inventory levels to be able to take advantage of any customer needs.

Jim Sidoti: All right, Thank you.

Fred Lampropoulos: All right, Jim. Thank you. Good to hear from you.

Operator: (Operator Instructions) Our next question coming from the line of Bill Plovanic with Canaccord. Your line is now open.

Fred Lampropoulos: Hey, Bill.

Bill Plovanic: Hey, thanks. Hey, how are you doing. My questions have been answered. Thanks.

Fred Lampropoulos: Okay. Thank you, Bill.

Operator: And our next question coming from the line of Steve Lichtman with Oppenheimer. Your line is open.

Fred Lampropoulos: Hi, Steve.

Steve Lichtman: Thank you. Hi, guys. Just a couple of quick modeling questions. One, Raul, does the tax rate guidance assume any stock-based compensation? And how much did that benefit you guys in '21 on the tax rate?

Raul Parra: Yes, so our tax rate, just to kind of -- thank you for the question because I wanted to kind of address this because we did have a pretty low tax rate last year at 18% on a non-GAAP basis. So the higher tax rate is assumed in our guidance, as you mentioned, at 22%. I will call out that kind of our base rate on a non-GAAP basis is around 23.5%, just to make sure people understand.

And so we've built in some benefits for exercise of stock options this year. And we usually weigh that towards the back half of the year just as a -- for modeling purposes. And that's really kind of, I guess the -- the color behind it is we've assumed kind of our base rate and some benefits to the stock options. And obviously, we hope for those to come in the back half of the year.

Steve Lichtman: Got it. Okay, thanks for rolling in. Just secondly on the cadence for the year, you're trying to map that out. I think that's true. So the first quarter on the top line you're saying will be above average because of the comp. But what drives the, I guess, the greater pressure on the bottom line in the first quarter versus the rest of the year? Can you walk through that a little bit?

Raul Parra: Yes, so we did call out an 8% to 16% decline in the quarter. A lot of it is around the COGS inflation pressures that we're seeing. In addition to, if you remember, we shut down during the December holiday period, and then it takes us time to ramp back up in the first quarter. So there's a combination of those two with the inflationary pressures that we're seeing, plus just the normal cadence in our manufacturing process.

Steve Lichtman: Got it. So it's really on the COGS side that will be a little bit elevated earlier on and (inaudible) okay.

Raul Parra: And a little bit of operating expense, too, right, just because...

Fred Lampropoulos: Yes, well, there's more and more access from our people getting out. And of course, hopefully what comes from that, we hope will be increased revenue down the road. So there's a little bit more expense than we had last year.

Steve Lichtman: Okay, got it. All right. Thank, guys.

Fred Lampropoulos: Yes. Great. Thank you.

Operator: I'm not showing any further questions at this time. I would now like to turn the conference back to Mr. Fred Lampropoulos for any closing remarks.

Fred Lampropoulos: Well, again, thank you very much for joining us. Again, I want to let you know that how pleased we are with our performance last year. We think that creates great momentum for the business, our commitment to the Foundations for Growth, and the track that we've been on is something we're going to stick to as why we're looking at other opportunities and continuing to stick with our research and development in our core products.

So those are important issues. I think that pretty well covers it. We appreciate you being there. Raul and I will be around for the next 2 hours, 3 hours, and we'll pick up questions and try to clarify things that you may have. Thank you for joining us. Thank you for your interest in the company, and all best wishes. Signing off now from Salt Lake City. Good Night.