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CORPORATE PARTICIPANTS

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

CONFERENCE CALL PARTICIPANTS

James Philip Sidoti *Sidoti & Company, LLC - Research Analyst*
Jason M. Bednar *Piper Sandler & Co., Research Division - Director & Senior Research Analyst*
Jayson Tyler Bedford *Raymond James & Associates, Inc., Research Division - MD & Senior Medical Supplies and Devices Analyst*
Lawrence H. Biegelsen *Wells Fargo Securities, LLC, Research Division - Senior Medical Device Equity Research Analyst*
Michael John Petusky *Barrington Research Associates, Inc., Research Division - MD & Senior Investment Analyst*
Michael Stephen Matson *Needham & Company, LLC, Research Division - Senior Analyst*
Steven Michael Lichtman *Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst*
Zachary Day *Canaccord Genuity Corp., Research Division - Associate*

PRESENTATION

Operator

Welcome to the Second Quarter of Fiscal Year 2023 Earnings Conference Call for Merit Medical Systems, Inc. (Operator Instructions)

Please note that this conference call is being recorded and that the recording will be available on the company's website for replay shortly.

I 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's Second 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***

Thanks, 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 upon reasonable assumptions, they are subject to unknown risks and uncertainties. The realization of any of these risks or uncertainties as well as extraordinary events or transactions impacting our company could cause actual results to differ materially from those currently anticipated.

In addition, any forward-looking statements represent our views only as of today, July 25, 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 sections entitled Cautionary Statement regarding forward-looking statements in today's press release and 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 sections of our press release and 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 second 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 June 30, 2023. We will then open the call for your questions. Now beginning with a review of our second quarter revenue performance, we reported total GAAP revenue of $320.1 million in the second quarter, up 9% year-over-year.

Our total GAAP revenue growth was driven by 9% growth in U.S. sales and 8% growth in international sales. Our total revenue increased 9.1% year-over-year in the second 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 and contributions from the 2 acquisitions we announced on June 8, 2023.

Our second quarter revenue results were notably stronger than the growth expectations that we outlined in our quarter 1 earnings call. Specifically, we shared our expectations for organic constant currency revenue growth in the range of 5% to 7% year-over-year in quarter 2. Let me now provide you with a more detailed review of our revenue results in the second quarter, beginning with the sales performance in each of our primary reportable product categories. Note that 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. Second quarter total revenue was driven by 9% growth in our Cardiovascular segment and 6% growth in our Endoscopy segment. Constant currency growth exceeded the high end of our expectations in our Cardiovascular segment, while Endoscopy sales were softer than expected in the second quarter. Sales of our peripheral intervention products increased 14%, representing the largest driver of total cardiovascular segment growth again this quarter.

Within the PI product category, sales of our access, radar localization and embolic products increased 19% and together represented nearly 60% of total PI growth year-over-year, and sales of our drainage and angiography products increased 12% and together represented roughly 1/4 of our total PI growth in quarter 2. We are proud of the continued strong performance across a number of key products in our PI category.

Though I would be remiss if I didn't call out the largest contributor to our total PI growth again in quarter 2, our highly differentiated SCOUT radar localization product line. We have been pleased with the market response to our SCOUT mini reflector as well during the first full year post commercial launch. Continuing on with a discussion of our quarter 2 revenue growth drivers, sales of both our Cardiac invention products and our OEM products were key contributors to our total Cardiovascular segment growth this quarter, increasing 6% and 14% year-over-year, respectively.

CI product sales come in roughly in line with the high end of our expectations driven primarily by strong growth in sales of both our angiography and hemostasis products, which increased more than 20% year-over-year. Sales of our access and our EP CRM products increased in the mid-single digits, which offset low single-digit declines of our intervention products. Sales of our OEM products exceeded the high end of our growth expectations, which we attribute principally to continued improving demand from larger customers in multiple categories including EP, CRM, coatings and kits products, which together increased 50% year-over-year in quarter 2.

Importantly, Merit's demonstrated ability to meet this growing demand is a key driver of this track record of growth. Sales of our custom procedural solution products increased 1%, which was notably better than the mid- to high single-digit declines we expected in quarter 2. This upside was driven primarily by stronger-than-expected demand of our CPS products from U.S. customers which offset mid-single-digit declines in our sales of our CPS products to customers outside the U.S.

Finally, sales in our Endoscopy segment increased 6% and which is below the growth range we assumed in our second quarter guidance. While we are pleased to see the underlying growth trends in our Endoscopy business improve in quarter 1, as expected, Endoscopy results continued to experience business disruption as we continue to navigate material shortages, supply chain constraints and work on qualifications for a new vendor. As discussed on our quarter 1 call, we had anticipated improvement trends as we move through the year and mid-teens growth for our endoscopy business in 2023.

Our updated guidance reflects the softer-than-expected sales results in quarter 2, and we are cautiously optimistic that we will continue to see improving trends and mid-teens growth in our endoscopy business in the second half of 2023. Now turning to a brief summary of our sales performance on a geographic basis. Our second quarter sales in the U.S. increased 9% year-over-year. Sales to U.S. customers came in roughly $4 million above the high end of our growth expectations, approximately $3 million of this was better-than-expected organic growth in the period.

Our U.S. growth performance reflects continued strong execution and overall improving trends in the U.S. market during the second quarter particularly in our direct business during the months of May and June. International sales increased 10% year-over-year, exceeding the high end of our expectations in the quarter. APAC was the primary driver of the better-than-expected results, although both the EMEA and Rest of World regions were at the upper end of our growth expectations in quarter 2. APAC growth was driven by sales in China, which increased 23% year-over-year as the improving trends in March that we discussed on our quarter 1 call continued into the second quarter.

In summary, we are extremely pleased with the strong execution in the second quarter and throughout the first half of 2023. The overall environment remains challenging, but is improving overall and our team is executing well and remain focused on a multiyear strategic plan. With respect to our financial performance in the second quarter, we believe the results continue to demonstrate that the team's hard work and commitment to our Foundations for Growth program are paying off.

Non-GAAP gross and operating margins of 51.4% and 19.9%, respectively, for the quarter and 50.8% and 18.1% for the first half of '23. These are impressive improvements in our profitability. While we are not losing focus and we remain confident in our team's ability to deliver our financial guidance for fiscal year 2023 and continued progress in the 3-year -- in year 3 of our Foundation for Growth program and the related financial targets for the 3-year period ended December 31, 2023.

Now before turning the time of the call over to Raul, I would like to take a few moments discussing the strategic acquisitions, which we announced last month. On June 8, we announced 2 acquisitions, the first was a portfolio of dialysis catheter products and the BioSentry, Biopsy Tract Sealant System from AngioDynamics for a total cash consideration of $100 million. Acquiring these assets broadens our therapeutic platforms. It strengthens our position in the dialysis and biopsy markets and expands the foundations of our growing specialty dialysis device offering which includes WRAPSODY Cell-Impermeable Endoprosthesis, the HeRO Graft and the Surfacer Inside-Out Access Catheter System.

Many dialysis patients rely on these solutions to receive vital therapies. We believe that by combining this portfolio of interventional solutions within Merit will allow us to leverage our physician relationships, our commercial infrastructure to serve more patients in the multibillion-dollar dialysis market. The acquired dialysis catheter portfolio includes the innovative BioFlo DuraMax dialysis catheter with Endexo Technology, a proprietary material more resistant to thrombus accumulation in-vitro compared to conventional noncoated dialysis catheters. Thrombus formation can block blood flow through a catheter preventing adequate dialysis treatment.

In addition to the dialysis portfolio, we also acquired AngioDynamics BioSentry Biopsy Tract Sealant System, which, again, we believe, strengthens our position in the biopsy market. The BioSentry is designed specifically to reduce the incidence of biopsy-related pneumothorax. Pneumothorax is a potentially life-threatening complication that can extend hospitalization and then occurs in approximately 1/4 of patients undergoing lung biopsy.

The second acquisition we announced was an asset purchase agreement completed in May to acquire the Surfacer Inside-Out Access

Catheter system from Bluegrass Vascular Technologies for a total cash consideration of $32.7 million. Bluegrass Vascular is a privately held company that Merit knows well having established an equity investment in the company and serving as the exclusive global distributor of the system from 2016 through 2022.

The Surfacer is a unique device designed to obtain rightsized central venous access in patients with venous obstructions, providing this population with access to life-saving therapies, including hemodialysis and chemotherapy. Importantly, these acquisitions of assets from AngioDynamics and Bluegrass Vascular are consistent with our stated objective to selectively invest to expand our product portfolio in key strategic markets that leverage our existing commercial footprint.

In addition to the strong strategic rationale, we believe the financial profile of these acquisitions is compelling. We expect these acquisitions to add approximately $30 million of revenue on an annualized basis and to be accretive to both our non-GAAP net income and non-GAAP earnings per share in the first full year post closing and accretive to our non-GAAP gross and operating margins, non-GAAP net income and non-GAAP earnings per share in the second full year post closing. The integration is underway, and we expect to continue these assets to contribute approximately $13 million to $15 million of revenue in fiscal 2023.

With that said, let me turn the call over to Raul, who will take you through a detailed review of our second 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 second quarter of fiscal year 2023. 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.

Gross profit increased approximately 13% year-over-year in the second quarter. Our gross margin for the second quarter was 51.4% compared to 49.3% in the prior year period, representing the highest second quarter gross margin in the company's history. The increase in gross margin year-over-year was primarily due to favorable changes in product mix, improved freight and distribution expenses as well as other FFG-related efficiencies.

As expected, our second quarter gross margins were impacted by the inflationary headwinds we are seeing in freight, logistics, labor and raw materials. With respect to freight specifically, we're still seeing the headwinds to gross margin as expenses are still higher than pre-COVID, but freight expense have significantly improved compared to the prior year period. The 200 basis point increase in gross margins year-over-year exceeded the high end of the expectations we outlined on our Q1 call, which called for gross margins to increase 70 to 130 basis points year-over-year due primarily to fixed cost leverage on the better-than-expected sales performance in the period.

Operating expenses increased 13% year-over-year in the second quarter. The year-over-year increase in operating expenses was driven by a 14% increase in SG&A expense and an 8% increase in R&D expense compared to the prior year period. The increase in SG&A expenses was primarily due to increased labor-related costs associated with headcount as well as increased travel and marketing costs to promote sales as restrictions continue to lift post pandemic. Our operating expense performance in Q2 was better than expected and reflects strong operating leverage, principally due to our continued focus on expense management and prioritization of investments to support our future growth initiatives.

Total operating income in the second quarter increased $7.1 million or 13% year-over-year to $63.6 million. Our operating margin for Q2 was 19.9% compared to 19.1% in the prior year period. The 70 basis point increase in operating margin was driven by a 200 basis point increase in our non-GAAP gross margin. Offset partially by a 130 basis point increase in our non-GAAP OpEx margin compared to the prior year period.

Second quarter other expense net was $3.4 million compared to $1.1 million last year. The change in other expense net was primarily related to an increase in interest expense associated with increased borrowings and rising interest rates, increased expense associated with realized and unrealized foreign currency losses.

Second quarter net income was $47.6 million or $0.81 per share compared to $42.3 million or $0.73 per share in the prior year period. We are pleased with our profitability performance in the second quarter, where we delivered 13% growth year-over-year in non-GAAP net income and 11% 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 June 30, 2023, we had cash and cash equivalents of $72.1 million, total debt obligations of $340 million and available borrowing capacity of approximately $507 million compared to cash and 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 June 30 was 1.2x on an adjusted basis. We generated $11.5 million of free cash flow in the second quarter.

Cash from operations decreased 55% year-over-year in the second quarter as a strong improvement in GAAP net income year-over-year was offset by a material increase year-over-year and use of cash for working capital. There were 2 primary drivers of the increase in working capital year-over-year. One that we have talked about in recent quarters, the other is nonrecurring in nature.

Specifically, the increase in second quarter working capital use was due in part to a decrease in accrued expenses related to payment of the final Cianna Medical milestone payment of $13.3 million, $12.5 million of which impacted operating and free cash flow in the period. This is a result of an accounting rule that required treatment of this specific final payment as cash flow from operations versus cash flow from financing. The other notable driver of working capital use in Q2 was related to the strategy we have discussed on prior calls, to proactively invest in our inventory balances to build the requisite safety stock and ensure high customer service levels.

We continue to expect to generate strong free cash flow generation in 2023 and the majority of which we continue to expect will be generated over the second half of the year. Turning to a review of our fiscal year 2023 financial guidance, which we updated in today's press release, we have included a table in our earnings press release, which detail the updated ranges for each of our formal financial guidance items and how those ranges compared to the prior year period. We continue to expect GAAP net revenue growth of approximately 7% to 8% year-over-year. The GAAP net revenue guidance range now assumes net revenue growth of approximately 7% to 8% in our Cardiovascular segment, net revenue growth of approximately 12% to 13% in our Endoscopy segment, and a headwind from the changes in foreign currency exchange rates of approximately $4 million.

Excluding the impact of changes in foreign currency exchange rates, we expect total net revenue growth on a constant currency basis in the range of 7.3% and to 8.5% year-over-year in 2023. Note, the midpoint of this range now assumes approximately 9% growth year-over-year in the U.S. and approximately 6% growth year-over-year in international markets. compared to 6% and 7%, respectively, assumed in the guidance provided on our first quarter earnings call. The higher U.S. constant currency growth expectation versus prior guidance reflects the stronger-than-expected second quarter results and the anticipated contribution from the aforementioned acquisitions.

The lower international constant currency growth expectation versus prior guidance is driven by the EMEA and APAC regions, specifically in Russia and China. We have revised our outlook for sales in Russia over the second half of 2023 in response to the Department of Commerce's announcement in late May that they are strengthening existing sanctions under the export administration regulations against Russia and Belarus. The additional rules and approval process defined by the Department of Commerce has challenged our ability to meet the revenue expectations in these countries versus what we had assumed in our original guidance for 2023.

With respect to China, sales results have modestly exceeded expectations over the first half of 2023. However, we have moderated our growth expectations in China for the second half of 2023 as we expect headwinds to growth related to recently announced VBP programs later this year. Our total net revenue guidance continues to assume contributions from the acquisition announced on June 8, 2023 and from their respective closing dates through December 31, 2023, in the range of $13 million to $15 million.

Excluding revenue from these acquisitions, our guidance reflects total net revenue growth on a constant currency organic basis in the range of approximately 6% to 7% year-over-year. With respect to profitability guidance for 2023, we have updated our GAAP net income and diluted earnings per share ranges to $76 million to $81 million and $1.30 to $1.39 compared to $87 million to $92 million and $1.49

to $1.57 per diluted share previously. Our non-GAAP net income and diluted earnings per share ranges remain unchanged.

For modeling purposes, our fiscal year 2023 financial guidance now assumes non-GAAP gross margins in the range of approximately 50.7% to 50.9%, up 200 to 220 basis points year-over-year. Non-GAAP operating margin in the range of approximately 18% to 18.2%, up 110 to 130 basis points year-over-year. GAAP other expense of approximately $13 million compared to $6 million previously and non-GAAP other expense in the range of $11 million to $12 million compared to approximately $6.6 million previously.

The increase in both ranges is primarily related to higher interest expense on incremental borrowings related to our acquisitions in June 2023. Non-GAAP tax rate in the range of 21% to 22% compared to 21.5% to 22.5% previously and diluted shares outstanding of approximately $58.5 million. Lastly, we would like to provide additional transparency related to our growth and profitability expectations for the third quarter of 2023. Specifically, we expect our total revenue to increase in the range of approximately 5.5% to 7.5% year-over-year on a GAAP basis and up approximately 5% to 7% year-over-year on a constant currency basis.

Note, the midpoint of our third quarter constant currency sales growth expectations assumes approximately 8.5% growth year-over-year in the U.S., including approximately $6 million of acquired revenue and approximately 3% growth year-over-year in international markets. With respect to our profitability expectations for the third quarter, we expect non-GAAP gross margins in the range of approximately 50.3% to 50.6%, up 190 to 220 basis points year-over-year. Non-GAAP operating margins in the range of approximately 16.6% to 17.1%, up 50 to 100 basis points year-over-year. These margin expectations, combined with the higher interest expense year-over-year are expected to drive a year-over-year change in non-GAAP EPS in the range of down 5% year-over-year on the low end to up 3% 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 lines for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) First question comes from the line of Steve Lichtman of Oppenheimer & Company.

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

Just a quick question on the AngioDynamics product acquisition. Wondering if you could talk about sort of the early feedback from the field and what you see the key opportunities to accelerate the sort of underlying growth of those products now under the Merit umbrella .

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

Steve, this is Fred, and thanks for the question. First of all, the strategy has always been to be able to strengthen and get ready for the Rhapsody, which will be around here in the near future. And to take a look at the Surfacer, the HeRO, and then how all of those products and then to align a sales force along with that and be prepared for it. So that is the basic thinking, and we think it's sound. I mean we wouldn't have done the deal. We also are, of course, transferring the product to Mexico, and we have the guy that did our Becton, Dickinson deal, Greg Fredde, who's sitting in the room with us, and he's running that program. So I think that it's an area that we know our customers are I think 99% or 98% were existing Merit customers.

So we feel strongly. I think the program is coming along as planned. And going to the question of growth, and without criticizing anybody else. Essentially, on the biopsy side, there was 1 product sold in Europe from the company we bought it from, from Angio Merit has a broad direct sales force. All of it is all distribution. And very candidly, it's something that we felt like we now have that full portfolio, which I have to say, by the way, is something that nobody else has to be able to have the peritoneal, the acute, the chronic, the Surfacer, the HeRO, the Rhapsody, I mean, who wouldn't want to have that.

So the positive thing, I think, from customers is we love having all these pieces and all the access part of it, and we appreciate it. We've reached out to all those customers. We went order to cash almost immediately, and we're in the process of now transitioning over to our facility in Mexico. So I think we continue to be optimistic about the opportunity and the ability to use this product to get growth out of it. Because you're right, it was something that, unfortunately, from -- they didn't do it, they just didn't focus. For us, it's an exciting opportunity. One of the best I've seen, and we'll look forward to reporting, I think, this -- in the success of this in the future. I hope that answers your question.

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

Yes. And then just secondly, following up on your comments on the end markets, Fred. You talked about improving end markets. You also talked to another point about some challenges out there having come in better than expected here in the first half. As you look back, what are the biggest improvements you've seen in the end markets here over the last 6 months plus? And what are still some of the challenges that you think you need to navigate? .

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

Yes. I'll hit a couple of these and I'll ask Raul to weigh in on these. Listen, I think the U.S. market is doing fine. There would continue to be challenges in other areas. But we still see growth across the entire gamut of our product lines. You can see the numbers on OEM where, again, reliability becomes such an important factor. People buy from us because they're reliable, we're reliable. And that goes a long way. Other people have had shortages. Now we're not without headwinds and that sort of things. Raul, let me give you a few minutes or seconds or whatever you want to do, just do you want to comment on that?

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

Yes. No, look, I think we continue to be excited about the business, Steve, obviously, had great results for Q2. I think when you look at the back half of the year, the implied organic constant currency revenue growth is 6% to 7%, we did -- I think it's important to call out that we did let some of that beat flow through into the U.S. market.

So that growth is going to go 7% to 8% versus the 6% to 7% we previously had. I think when you look at the international market, there's still some kind of noise out there and we've accounted for it there, which is why we didn't raise revenue guidance. But if you look at the international organic constant currency growth, it's approximately 5% to 7% versus a 7% to 8%. And that's really due to 2 specific issues. One was the EMEA kind of the Russia issue, right? There's different requirements now to sell into Russia, which we've accounted for as part of our guide. And then the APAC region, we got additional volume-based purchasing out of China that will hit us in the fourth quarter of this year or could. We haven't been very good at guessing the stuff, but it's accounted for in our forecast. And so those are really the 2 things. We're excited about how the business is doing, quite frankly.

Operator

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

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

Just picking up maybe on the China comment. Strong 2Q, I imagine there was probably a bit of a catch-up there, but I'm just more interested in the VBP commentary. So the guide assumes an impact in the fourth quarter. I guess I'm just curious, are these VBP programs in place now? Or does the guide reflect what you think may happen to announce VBP programs?

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

So they are announced VBP programs that the Chinese government has announced that will happen in the second half of 2023, Jayson. So as you know, we did have an impact that we had already included in our guidance for the year, our original guidance that we put out in Q1. This is incremental to that. And so again, given that we had strong results, we didn't really have to change our guidance just given that we had such a strong beat that we were able to kind of maintain our guidance. .

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

And it's reflected in our APAC numbers as well.

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

Exactly.

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

So it's in our model.

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

Okay. And to be clear, the expectation it starts in 4Q, not 3Q?

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

Yes. In the second half, look, I mean, with China, it will change tomorrow, Jayson. I mean I'll just say the second half, and I think that will account for any changes there.

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

Okay. And then just on the third quarter gross margin, very strong 2Q, and I realize it always, I think, trends down sequentially. But is there an impact from the acquired assets that's weighing on the third quarter or fourth quarter with GM for that matter? .

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

For the third quarter, look, it's all in, right, what we think is going to happen. Most of what you're seeing is the impact from just reduced revenue. We've got fixed cost that we have to cover. And really, that's what's driving it. We always see a decrease in revenue in the third quarter. We always typically see a decline in the gross margin also and also in operating margin and earnings for that matter. So as you know that, Jayson, but that's really what's driving those -- that impact. .

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

Okay. And then just maybe last one from me. In terms of Endoscopy, that was probably the only wrinkle I'd say in 2Q, how confident -- it sounds like it's more of a supply issue than a demand issue, just the level of confidence here that you kind of have this fixed and under control over the next quarter or 2.

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

Yes. Listen Jayson. We finished, I think, 80%. I mean, we got -- all the other things done. In 1 of the units, there's more work to be done, and we just want to make sure they're right. So the vendor, we have absolute confidence in. I mean they've done extraordinary work and transferring this over. I think we handled it as well as we could. So -- and I think what last quarter was, what, 12%, 13%, 14%? .

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

Yes. I mean, I think really, it's really just these final qualifications that we're kind of waiting on, Jayson. I think we have a pretty good robust plan. And just -- this is one of the issues that Fred was talking about a little bit earlier with Steve's question, right? We just kind of -- there's still this kind of noise out there with supply chain and just availability of product. And so this is just 1 of the -- 1 areas that kind of hit us. .

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

A lot of these little things out there. I hope that helps you a lot Jayson. .

Operator

Our next question comes from the line of Larry Biegelsen of Wells Fargo. .

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

Congrats on a nice quarter here. Raul, I'm just -- I have to admit, I'm a little confused on the numbers. I thought I heard you say the second half implied organic growth is 6% to 7%, isn't it 6% to 7% still organic for the full year?

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

Yes.

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

Okay. And so if it's 6% to 7% for the full year and you did, I think, about 9.5% in the first half, tell me if I'm wrong, but the second half implies about 4%. Is that right?

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

That's correct, Larry. It does go down sequentially.

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

Yes. Okay. So on the China and Russia, headwinds. So Russia, what percent of sales are from Russia for Merit? And what is the implied impact in the second half guidance? And on China, could you tell us the same thing, which areas -- last time you had a VBP impact, you told us how much it was and in what area. So can you tell us what you're assuming for China, the amount and in what areas?

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

Yes. We're not going to give that detail, Larry. I think the last time we did this was a year ago, and we spent the better part of that year explaining $10 million. I think you can just -- it's implied in our guidance, and it's 1% of the APAC growth change reflected in our guidance, if that helps.

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

Okay. And Russia, have you disclosed a percent of sales for Merit? I can't remember. .

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

Again, yes, we won't disclose that. It's baked into our guidance. Yes.

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

I got it. Okay. Fair enough. Fred, I'm just curious, what's your view of catch-up or deferred procedures? Some areas are seeing that. Does Merit have areas that you think would benefit from procedures that were deferred during the pandemic? And what are you assuming in the guidance? .

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

Yes. Larry, I think you stated it properly. That is there are some areas, I think I stated last time we visited that they're having problems staffing OBLs, let's say, in Texas and maybe in the Midwest, someplace here in Utah, as an example, that's not a problem. In other areas, it's -- they've been able to solve it. So it's spotty, but higher, but we do believe there's a lot of pent-up demand out there. .

Operator

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

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

I'll echo the congrats here on a strong result here. I wanted to maybe follow up on 1 item of strength that just really stood out to us in the quarter, and it's really for the first half of the year, but we'll focus on 2Q. And that was gross margins. And these aren't just moving higher on a sequential basis, so you're hitting new record highs in gross margin, which is just really extremely impressive in this environment. Not a lot of companies can say that just given inflationary pressures. .

I understand the guidance here for third quarter, but could you elaborate maybe with quantifying some of the contributors here that you're seeing in the second quarter on gross margins and also talk about your level of confidence and sustainability of those gross margin levels beyond this year? Anything there? And to what extent might be able to consider additional upside that could materialize through additional pricing actions or benefits from these product line transfers to Mexico, anything like that?

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

Yes. Look, it's a great question. We expect strong gross margin expansion in '23 despite all the headwinds that are out there. I think we were very vocal when we give our initial guidance, and we continue to be happy with the way it's progressing. A lot of the contribution is really coming from our FFG initiatives, which include pricing. It also includes covering some of our fixed cost leverage. And then tailwinds to gross margin that we're really getting is the freight and logistics, which we've really focused on and have been very vocal about making sure that we can get things back on the ocean. As far as beyond 2023, we're not going to talk about that. But as you can imagine, things are -- we'll continue to do work and there's transfers and things that continue to happen. So I'll leave it at that. .

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

And I don't want to rehash what you just said because I agree with it all. But I think Raul made a comment on our opening comments, that is it's working. FFG has worked, and we're now just starting to see some of the benefits of that. It's not you make a decision or overnight it changes, it takes time for these things to work through a system and through a business and it's working and it will continue to work. .

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

And Jason, the reason we've been so confident in the gross margin is because we've been working on some of these programs for not a month or 2. I mean, years in certain cases. So again, we still got another 6 months to go, but the plan does call for gross margin expansion. .

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

Okay. Perfect. That's really helpful, guys. Really comprehensive too. Maybe to shift gears a little bit, the recent transaction you executed with Angio, it looks like a fairly low risk move, 1 that probably has some nice operating margin upside and also even revenue growth upside you talked about earlier in the call. But on the deal, glad this you're able to find an asset to you're liking, can you talk about maybe philosophically about how you're approaching the potential for additional M&A from here? Is there still an appetite do you need to get through a certain portion of the digestion period with Angio before taking that next M&A step. And have you identified procedural gaps that you'd like to fill externally as you did with Angio dialysis and biopsy? .

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

Well, thank you. I think we did a lot of work to sort this out and find it and then to execute it. I'm very confident in our ability in the transition agreements and things like that of the people that are engaged in as I mentioned, Greg earlier in the history we've had in the past and very candidly, our associates in Mexico very -- these guys know what to do. I think that there are opportunities out there I think that being patient and being wise and not frustrating what we're doing has been the key to it. I mean, you can do -- there's a lot of stuff out there and a lot of people looking for money. But it has to fit the things and the criteria that we've set. And if it doesn't do that, it might be a great technology, but it's just not going to work for us. We like what has worked, but I think it's -- to do the things that we want, I think is maybe more difficult. And I think our shareholders are going to have to be patient. I think you hit the nail on the head. I think the risk factor for this transaction was one that we felt that we could digest. But I've also learned from the past, and that is when you try to do 2, 3 big deals or product transfers, it really, really pins out your resources and capabilities.

I think we've learned from that. And we all know about that period of time in aligning the sales forces and having a Chief Commercial Officer and doing the changes that we've made over the last several years will be very, very helpful. So patience and that patience will be rewarded from, I think, just good and wise choices. Raul?

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

Yes. And I'll add that we're well capitalized with sizable borrowing capacity, and we're only at 1.2x on a net leverage standpoint.

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

Appreciate that, really helpful perspective. If I could just squeeze in one more. Just how much pricing might have added in the quarter? And then any views you have on what pricing might be within the second half of the year in your guidance? .

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

Yes. We're not going to disclose that. We don't want to get into the volume versus pricing discussion, but I appreciate the question, but just know that it is having an impact. .

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

And it is one of our foundations for growth pillars.

Operator

Our next question comes from the line of Mike Matson of Needham & Company. .

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

Yes. I guess I'll start with the acquisitions as well. So looking at the products that you acquired, the dialysis products specifically in the slides, it didn't look like there was a little bit of overlap maybe between some of the acquired products and some of the catheters that Merit was already selling. So is that the case? And is there any risk of any kind of cannibalization or dissynergies or anything there?

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

Yes, Mike, thank you. Listen, they have a number of catheters, but let me point out a couple of things that are very, very important. One, as part of 1 of those catheters, we end up with an acute catheter. Remember Merit's products are all chronic. These are the ones that have a cuff. Oftentimes in different types of accidents where someone has renal failure, this and that, you'll do these other products. Merit didn't have that. So that is really in addition, a smaller part of the revenues, but nevertheless, an addition. I think what we'll do is to go through and look at all this stuff. And just like any of our other product lines and the things that we've talked about, we will do that as well. I will say this, but I think that 1 of the things that I'm very excited about and have been for a long time is this Endexo, I'll call it a component of the BioFlo. The BioFlo is a big deal. We just don't think that it has been promoted. So I think that is something and we will look at this like anything else and try to come up with the right mix over time.

But I think for right now, it's getting this transferred, going through that transition, getting in place, meeting customer needs, getting our biopsy work done. And by the way, it's very complementary, as we've talked about to biopsy because they didn't have biopsy products. Merit does have biopsy products. So when we look at all the little tactical issues and how they fit into the strategy overall, we think that it's going to be a great opportunity. Raul, you want to add something?

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

I mean, if there's any overlap whatsoever, really, it's already in the numbers, but we would call it minimal.

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

Yes. So just to that point, whatever overlaps, will be replaced with something. And so we don't look at it as a cannibal or loss of revenue. .

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

Okay. I understand. And then just on the Bluegrass Surfacer product, I don't recall the slides having a kind of estimate of like the market opportunity for that? Like, I mean, is this something that could ultimately be tens of millions of dollars of revenue. And then is it also kind of a I mean where is the gross margin? Is it kind of significantly higher than your overall margins? Or is it in line or...

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

Mike, let me answer that by saying that we think it is a contributor to gross margin. We've been selling this product for 4 or 5 years, but it was right in the middle of COVID, and it was approved in Europe and then we had to get some work done in the U.S. So it was a difficult time to introduce a product like this. All of that being said, I want to go back to the strategy. It's what it fits into what it leads to, how it's complementary to the HeRO. And very candidly, a lot of input from physicians on how they like 1 group representing and they -- so we listened to what they did over the years. And when our distribution rights went away, we looked at it and said, this fits in this strategy and particularly as we moved in and looked at the chronic and acute dialysis products and biopsy and put all this together, there was a lot of thought that went into look how these will work and how will we market this and how does it differentiate the company. .

So I don't go into all of the specific products other than to say it is a product that we think will do very well and complement the strategy of the -- of this whole process, which were -- that, I think, is what we want to focus on is not 1 product, but the whole a lot because there's a lot of subtle things, like I said, acute versus chronic, things that generally might not be understood by the investing public. But the strategy is one that's worth talking about because it's so much work went into it. So I'm very pleased with the work and the thought that we did to come to that conclusion and then how we approached it. I think it was a relatively unique transaction.

Operator

Our next question comes from the line of Jim Sidoti of Sidoti & Company. .

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

So again, I guess everybody is focused on the transaction because it has been a while since you did one. When you completed the deal about 6 weeks ago, you thought -- you'd see about $15.2 million in transaction costs, about $3.5 million of interest expense. Six weeks later, those still good numbers? Or what are you thinking there?

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

Yes. The interest that's expected or implied is about $6 million or about $0.04 to $0.05 a for the year, Jim. And then you would have had some amortization, which I think you're capturing in that $15 million because the transaction costs won't be that significant. But a big portion of it will be amortization that obviously comes on as you fair value all the assets.

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

Okay. So of that $15 million, then it sounds like the majority of that will be in the second half of the year.

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

Yes. And in the number I have is roughly about $11 million just as a heads up. .

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

That's an amortization.

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

Yes, just all in for the expenses and amortization.

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

So that's for all in.

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

Yeah. We might have given that since the last time we talked, Jim, but yes, we show $11 million.

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

Including amortization.

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

Amortization. Yes.

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

And so how much was in the first quarter -- second quarter, sorry.

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

It would have been probably about $6 million, somewhere around there, $5 million, $6 million. It would have been amortization and then we would have some banking fees.

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

Right. Okay. All right. And in terms of pricing, I know you don't want to get too specific, but is it fair to say that the price increases that you've put in place are sticking?

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

Yes.

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

Yes.

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

Okay. And I think you said earlier that continued price increases is part of the Foundations for Growth plan. So expect them to -- you'll continue to put in price increases in '23 and '24 or in '25 and '25?

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

We have a program of pricing that's an ongoing program. Some of these various issues were contracts that will come due, but it is a pillar of Foundations for Growth, and it will be a pillar of consideration and growth going forward. It's not going to go away. .

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

Yes. When I think of these Foundations for Growth, I always think of the foundational, there's a lot of things that we've changed, how we -- what we do or how we do it at Merit and this is just 1 of those pillars that Fred just talked about, obviously additional things, those things don't end on December of this year. That will obviously help us in subsequent years. .

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

All right. And then the last 1 for me on China. If I recall correctly, at the beginning of 2022, you were expecting some pretty significant hits in China because of the volume pricing and as we went through the year, they didn't materialize. So you're expecting them again, but what -- how confident are you that they'll actually happen? And is there a chance that the same thing could happen and they don't materialize in the back of this year?

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

Well, look, I mean, first of all, we are feeling the impacts of volume base purchasing within our P&L. And obviously, it's kind of hitting a little bit because we just continue to execute at such a high level and the gross margin expansion continues. So I just want to make clear up that we are seeing the impacts. You're right, Jim, we haven't been very good at kind of estimating the exact start of these things, but we do know that they're impacting this in China changes from day to day. .

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

By the way, about the same as everybody else on the planet. We've never been able to figure that out.

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

I think what we have been trying to do, and I think we've done a pretty good job of is just making sure that we're transparent with our investors and you guys know that, look, there's additional impacts that we hadn't accounted for, and we're just letting you know about those.

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

Yes. I guess the reason I'm confused is you just had a very good second quarter. Your guidance for revenue for the third quarter is pretty good as well. So it implies that the fourth quarter will be significantly slower growth. And I'm just trying to get in my head is that because of China or Russia or I'm just -- are you being conservative? Just trying to understand what's going on.

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

Again, I think we'll just kind of stick to our guidance that we feel pretty good about our guidance that we've given and the growth rate that we expect for the year, which is 6% to 7%. The growth expectations in the U.S. have not changed versus what our prior guidance we've assumed. It's really kind of those impacts that we're feeling from EMEA and APAC.

Operator

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

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

So I guess I wanted to ask Raul, on the expectations for CapEx in the second half, I mean that was up at $55 million for the full year, and it certainly seems like that is unlikely to come in that high. Can you just comment on what your thoughts are on CapEx for the full year? .

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

Yes. We obviously have seen an increase in working capital, and we're very focused on our free cash flow target for the year. We have slowed down some of the CapEx, and that will feed through the rest of the year, Mike. But our expectation is still to -- we're still shooting for that $300 million of free cash flow.

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

Okay. But I mean in terms of CapEx, I mean, I think at 1 point, and forgive me, I may be getting this wrong, but hadn't you said that CapEx would probably be somewhere around $55 million or might maybe misremembering that? Or I like...

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

Yes, you're right. We haven't changed that. I guess I'm saying that we did slow it down in the second quarter, and so that will kind of feed through, right? But we haven't changed the guidance. We haven't changed any guidance for free cash flow for that matter.

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

Or CapEx. It can slow down for the quarter, but for the year, we haven't changed anything.

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

There's a lot of timing-based things that happen with capital expenditures and just free cash flow, in general, to be honest.

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

Okay. Okay. All right. Okay. So in terms of the earnings guide for Q3, sort of the good possibility that maybe you have a couple of pennies negative comp or a couple of pennies positive comp essentially. I mean is a big -- a meaningful part of that around whether Endoscopy sort of really continues to lag? Or what essentially is sort of the delta between the 2?

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

It's really just the revenue right, that will drive it in the gross margin, right? I mean, I think we've got the operating expenses that we've increased incrementally from quarter-to-quarter, we've got the incremental interest expense that's going up. So it's really what impacts our third quarter every year from an earnings perspective and our margin perspective is really that revenue and how much we -- where we end up on that between the high end and the low of the guidance -- of the commentary we gave.

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

Okay. And then just 1 housekeeping and I probably should be able to figure this out, but I just want the extra sort of handholding. In terms of interest expense that you expect in the second half, I mean, is that roughly like $7.5 million for the second half, something like that? Or is it...

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

Yes. I mean it's $0.04 to $0.05, Mike, it's the best way to kind of put it. And obviously, a big portion of that is going to happen in the back half of the year. .

Operator

Our final question comes from the line of Bill Plovanic of Canaccord Genuity.

Zachary Day ***Canaccord Genuity Corp., Research Division - Associate***

This is Zachary on for Bill. Again, just on the free cash flow, you sort of touched on it there, but given you're at just over $13 million from the first half and the goal for the year-end was $300 million, can you provide a little more color on how you're looking to specifically get there? Is it really just the CapEx? Or is there anything else you can give us? .

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

Yes. There's also some work being done on inventory. As you know, we've tried to move our -- we haven't tried. We've actually done a pretty good job of moving our freight from ocean or from air to ocean. So that obviously creates more inventory. We do have a plan in the back half to start to eat into that inventory. So it becomes in addition to free cash flow as opposed to taking away. In addition, we're just -- I'll call out that 1 of the things that happened in the second quarter, and it's not an excuse, but there is a kind of an accounting issue that happens when you originally fair value your contingent payments, anything that exceeds that fair value is actually it moves from financing and into operating cash flow. So that impact was $12.5 million.

So really in my eyes, we hit about $25 million in free cash flow. I want to call that out because it's kind of a unique thing. As you can imagine, we fair value this contingent payment 5 years ago before COVID, and everything else that happened. And so it's a good thing that we're paying the contingent payment above what we thought we would pay because that means that Cianna is doing much better than we anticipated, which is good for us. But I did want to call that out. And just as a highlight, I guess, we've generated over $200 million in free cash flow in the first 2.5 years of FFG despite all the headwinds in the global macro environment, supply chain, raw material costs, freight and distribution expenses, et cetera. So overall, I'm pretty excited, and we're still focused on that $300 million of cumulative free cash flow. And so we'll continue to work towards that. I think we've demonstrated, though, that this business is really capable of generating strong free cash flow, and we continue to expect this not only for this year but into the future.

Operator

Thank you. I would now like to turn the conference back to Fred Lampropoulos for closing remarks. Sir?

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

Yes. Well, okay, everybody. Thank you very much and for the staff. Thank you for your preparation. Raul and I will be around for the next couple of hours to do our one-on-ones. We appreciate you taking the time on a busy earnings season and all best wishes from Salt Lake City. Good night.

Operator

That does conclude our conference call for today. Thank you for your participation. You may now disconnect.