PODCAST TRANSCRIPT

Talking Research: Has medtech turned a corner?

First published: 22 September 2026

Katie Boyce: Every day patients benefit from medical technologies that would have seemed remarkable just a generation ago. Heart valves can now be replaced without open heart surgery, robotic systems are helping surgeons perform increasingly complex procedures and advances in diagnosis are enabling earlier treatments and better outcomes for patients. Technologies that once seemed like science fiction are becoming part of everyday healthcare and yet, for investors, the story has been far less straightforward. While innovation has continued, the medtech industry has had to navigate post-pandemic disruption, policy uncertainty and shifting market sentiment.

So, are these simply temporary headwinds? Or has something more fundamental changed in medtech? And after several tough years, has the sector now turned a corner?

Before we get started, a reminder that this podcast is intended for investment professionals only and should not be construed as investment advice or a recommendation. Any stock examples discussed are provided in the context of the theme being explored, and the views expressed are those of the presenters at the time of recording.

Hello and welcome to Talking Research, a podcast from Walter Scott. I'm Katie Boyce, an investment writer at the firm. And today, I'm delighted to be joined by investment manager Paul Loudon. Paul, welcome.

Paul Loudon: It's great to be here, Katie.

KB: Perhaps you could start by introducing yourself.

PL: Sure. I'm an investment manager on the Asia Pacific team here at Walter Scott. I joined the firm back in 2014. And over the twelve and a bit years that I've been here, I've been lucky enough to champion a few high-quality medtech companies. So, I'm delighted to join the discussion today.

KB: We'll come on to some of the headwinds I've mentioned in a second. But first, if we could take a step back and perhaps you could talk about why the medtech sector has been such a fertile hunting ground for investors over the years.

PL: I think there's a few factors that really explain why we've had some joy over the years picking high-quality medtech stocks. I think first and foremost, there are obviously some structural tailwinds that really support long-term growth in the space and how they're compounding over time. If you think about aging demographics, about new technologies and innovation, opening up new treatments, pathways, and paradigms, and also emerging markets, for instance, and long-term penetration runway there. So, it's lots of growth tailwinds.

You also have very high barriers to entry in the space. So, if you think about the intense regulatory oversight required of these products, these technologies; devices are going into people's bodies, so a lot of clinical trial intensity to truly factor in. So, that is hard to break into. There's also patent protection over technologies and also distribution as well. If you think about the relationships with doctors and surgeons, hospitals, all of this is really hard to break into.

A third thing that we really like is just the financial profile of many of these businesses. So, the industry leadership that the barriers to entry entail, often leads to oligopolistic positions, which confers very strong margin structures, pricing power, etc. So, a lot of these companies have prodigious cash generation, strong balance sheets, and high returns on capital, which is obviously attractive. And then, last but not least, I would say the defensive characteristics of the sector really appeal. So, a lot of these surgeries, these procedures are essential, urgent procedures, and the state of the economy or interest rates don't really factor into whether these will be carried out.

So, that kind of defensive nature as well really appeals. All of those factors combined make a pretty compelling area for stock picking.

KB: As you say compelling, but yet it struggled recently. Why is that?

PL: I think a confluence of factors of late have really weighed on sentiment over the past twelve to eighteen months. Firstly, we've had some high-profile healthcare macro headwinds in the form of things like the Affordable Care Act subsidy rollbacks. This has led to a reduction in the number of people being insured in the US by several million and also higher out-of-pocket, higher deductibles and so on. So, all of this is leading to concerns around potentially slowing procedure growth. We also have a Medicaid reform in the US, which again has just weighed on the overall

sentiment. It's not necessarily really clearly showing out in numbers yet, but that's definitely a high-profile headwind that the sector has been grappling with.

You then just have – which is related to this – hospital budgetary pressures, which, again, an ongoing headwind. And then, I think, also it's worth mentioning that the medtech space probably has been a source of funding for the AI trade, which has clearly garnered a huge amount of attention and capital inflows. So, I think all of that has certainly weighed on the sector.

KB: Confluence, as you say. And in this kind of environment, how do you and the team look at companies individually and work out what is temporary and what is more structural, in terms of the headwinds?

PL: Look, I think that's probably the hardest and arguably the most important part of the job, just when you have this kind of issue where there is a real debate as to whether it is short-term or structural. So, we really zero in on the key issues at hand and try to do everything we can to, firstly, gather the relevant facts. So, we'll confer with industry experts, with academics, with obviously the companies themselves. Not the just companies in question, but also any peers, competitors. We'll speak to end users of these products; be that surgeons, doctors, hospitals, etc., just to try and rebuild as deep and comprehensive a picture of the issue at hand as possible.

Then it'll be intensive debate. So, the team obviously meet frequently and these specific issues will be the absolute topic of debate. And we'll just try to ultimately use our collective judgment with all of the facts at hand, the experience we've garnered over the years to make the right call. And we'll not make that right call a hundred percent of the time, but if we make it more than more than we don't, then, you know, that's a decent outcome.

KB: And perhaps the best way to bring that process to life is to talk about a real example: Edwards Lifesciences, which treats structural heart disease. It's had a particularly rough couple of years. Perhaps you could explain what happened there.

PL: Sure. So, Edwards had a fantastic decade in the 2010s, leading up to COVID. It is the world leader in treating aortic stenosis. They pioneered a minimally invasive surgery called transcatheter aortic valve replacement. And…

KB: Which what does that do?

PL: It basically involves the insertion of a replacement aortic valve into your femoral artery in your thigh, guides it up through the artery and expands into the heart so you don't have to go through very disruptive open-heart surgery. So, truly a pioneering therapy. Unfortunately, like many other medtech companies, healthcare companies in general, COVID was a big challenge for them because hospitals were obviously preoccupied treating COVID patients. They were prioritising that emergency, and therefore, other procedures like TAVR took a back seat despite it being still an essential procedure.

So, with cath labs closed, they did have a pause during COVID. They recovered quite nicely 2021, 2022. But then in 2024, after this nice recovery, they basically had a bit of a road bump due to capacity constraints in the cath labs where the TAVR procedure is carried out. This was due to staffing challenges in hospitals, but also a wave of new structural heart procedures that came onto the market around that time, led to just capacity challenges. They couldn't quite hit their ambitious growth targets. They had to downgrade their guidance for the full year for TAVR, and that led to a very sharp share price correction on the day, which was obviously painful at the time.

Thankfully, the company has recovered since then, so it's done a good job at re-establishing trust and it's regained some momentum. But that roadblock, that step down, really kind of challenged the share price.

KB: But I guess two questions: one is, how do you and the team reassess that investment case when something like that happens, that one-day share price crash as you described it? And secondly, I guess a bit of explanation, why it's corrected so well.

PL: Yes. So, we ultimately still really believed in the company and the innovation engine at the heart of the company and the long-term growth runway for the procedure and the new growth avenues. And the specific reasoning for this capacity constraint, which was the cause of the guide-down. We just wanted to investigate that as best as we could. It started with engagements with the company. So, I think within the space of a month of that share price fall, we had three engagements with the C-suites to really just grill them on this excuse and just get an understanding of the issues at hand.

We also did some extensive travel to get out into the field and see hospitals first-hand to understand if this kind of cath lab constraint was literally playing out, as I said, in the field. We attended Capital Markets Day. I've been out to California, to Edwards' headquarters, as have other colleagues. So, pretty comprehensive research effort to get to the bottom of the specific issue. And for us, we kind of, really did fall down on backing management's explanation for the issue, and it's been gratifying to see that play out with a much more satisfactory growth since then.

KB: Absolutely. And what did that direct engagement tell you that the headlines and the reported numbers didn't?

PL: Well, I think it's one thing when a company, you know, justifies or explains an issue in a press release or pre-recorded earnings announcements. But to actually sit over the table from management teams, look them in the eye. These are companies that that we've known, or management teams we've known for a long, long time. And I've met the CEO on a dozen of occasions before. So, just seeing their facial expressions and really, kind of, understanding their body language and when you're pressing them firmly on this issue at hand, is very helpful. But also, I think this was an important but a specific issue.

There's a lot of other exciting growth drivers. So, also really ascertaining from management teams face to face, how excited they are about these kind of upcoming growth drivers, the clinical trials that we should really be paying attention to. So, just building that overall picture of the confidence and conviction that they have face to face, I think, was very valuable.

KB: Edwards is just one example, but – as I've mentioned – you've got a lot of experience in the sector and you've spent a lot of time talking to companies across the sector in recent times. What have they been saying about these recent challenges?

PL: You're right, Katie. So, we obviously invest in quite a few other medtech companies and meet many, many more. So, a lot of these challenges have been the main topic of conversation when we are engaging with management teams. And I think most companies are, you know, at pains to say that there's nothing drastic they're seeing in the numbers. If anything, it's very much at the margin. A lot of this is isolated within or really only Medicaid exposure or highly elective procedures where, again, many of these companies don't have a great deal of exposure.

So, we're not hearing huge concerns from management teams, but it's also fair to acknowledge that the situation has changed. It's evolved, and they're not shying away altogether. So, we need to be cognisant of that. But broadly speaking, there's still a lot of confidence out there.

KB: Great, and turning from those challenges you've mentioned with Medicaid and all these bigger issues. Within healthcare one of the biggest stories in the last couple of years has been GLP1s. And for a number of medtech companies that has been deemed a huge risk. Has that played out? Or are there also opportunities?

PL: So, I think the two examples I'm closest to would be Resmed and Stryker, and both of them, especially Resmed…

KB: And they do…? Just to be clear on what they do, Resmed?

PL: So, Resmed is a world leader in reducing sleep apnoea. And Stryker is a more diversified medtech company. But they do have a reasonably big business in orthopaedics, knee and hip replacements, and so on. So, in Resmed's case, I think, sleep apnoea, generally perceived to be a condition that afflicts larger patients. And therefore, if there is a reduction in obesity rates, what does that mean for sleep apnoea rates and therefore Resmed's business?

In Stryker's case, I think the bear case is that if there are people that are kind of less heavy and you know, less pressure on joints, that might mean fewer joint replacements.

But actually, I think in our experience, and certainly the companies have corroborated this, is there is a very reasonable argument to make that in both of these cases, the number of patients entering the funnel for sleep apnoea and, you know, other medtech procedures, in Stryker's case, the number of patients will increase.

KB: Why would that be?

PL: So, for sleep apnoea, for instance, it feels like with GLP1s, many more people are going to their doctors for weight-related issues. They're being encouraged to test for comorbidities or other conditions related to obesity like sleep apnoea. And one of the big problems with sleep apnoea is diagnosis rates are low. So, there are many, many, many undiagnosed patients out there. And we're seeing an increase in the diagnosis of patients.

So, while at the margin, some patients may lose weight and recover and not need Resmed's devices and so on, many more seem to be entering the funnel for the first time and really becoming new customers of Resmed.

So, we're certainly not seeing any obvious impact on GLP1s for the negative and if anything, potentially positive impact. But we'll obviously monitor that on an ongoing basis going forward.

And then with Stryker, again, yes, there might be the odd patient who doesn't require a knee replacement because they are lighter. But if this encourages many millions more who otherwise wouldn't be mobile at all, to be more mobile and then potentially, you know, use their knees and hips more again, that could add to more patients into the funnel.

KB: And when the market becomes concerned about a threat such as GLP1s, how do you as a team work out what is noise and what is genuine pressure on a company?

PL: So, I think this is a similar example to what you asked earlier about how you differentiate between, you know, short-term transient headwinds and long-

term structural change. And the same principles of deep research and fact-finding and really building that comprehensive picture is absolutely at play here. I think I'd add that in this kind of scenario, pretty deep population modelling, very extensive scenario analysis are very useful tools in which you can, kind of, try and gauge what impacts that these developments might have on population growth, prevalence, and conditions.

So, I think all of those tools at disposal have been used pretty extensively.

KB: One theme that's come up is innovation. Across medtech – as I mentioned earlier – it is a sector that is renowned for its innovation. Despite the recent headwinds, how would you characterise the current pace of change?

PL: I think "faster than ever" is the punch line. So, we certainly see a huge amount of, kind of, innovative activity. The R&D functions of these companies are humming along as fast as ever. Obviously, some technologies are accelerating the speed of innovation through things like machine learning obviously, 3D printing, digital twins. So, there's a lot of reasons that the speed of innovation is accelerating. I think Intuitive Surgical would be a good example of…

KB: Which makes robotics devices.

PL: Yes. So, minimal invasive robotic surgery systems, highly innovative company. And they are leveraging the over 21 million procedures, the data points of these procedures, to really train their next generation systems and glean enormously valuable insights as they develop these new platforms. Their latest Da Vinci platform, DB5, I think is a 10,000-times increase in compute power. So, the kind of, platform with which they can now innovate and speed up that cadence of innovation has really stepped up. So, huge amounts of innovation there.

I would say, though, just to kind of caveat that, ultimately, progress in this field is still constrained to some extent by clinical trials that need to be carried out. So, if you're testing a new heart valve, in order to really assess the safety of that valve and just the durability of that valve, you need to do an in-person trial that can take three, five, or even ten years if you really to want ascertain the durability of that valve. So, however fast the innovation is upstream, ultimately, there's still huge benefits to the incumbents that have this long-term clinical data. So, they've got the best of both worlds in that regard.

KB: And you're mentioning incumbents there. How should some of these market leaders… should they be worried about competition from China, India, and elsewhere?

PL: I think they should always be worried about competition. I think none of these companies can stand still and rest on their laurels because it's a very attractive industry to enter. The prize is large, so they need to expect competition. And historically, I think that was mostly from the markets they already operate in. But as you say, now in China and India, there are new upstarts that are gathering momentum there. I think five, ten years ago, they were relatively low-quality kind of copycats. Now I would call them maybe more high-quality, but still copycats.

So, we're definitely seeing much more high-quality competitive forces coming from these markets, yet to see real, kind of, groundbreaking innovation and pioneering alternative solutions coming. But we've had colleagues on the ground in China meeting with Intuitive Surgical's potential new threats from the East quite recently and very impressive what they're doing, but ultimately still…

KB: The innovation lies...

PL: Yeah. They are, in many respects, just kind of, mimicking what Intuitive have done. So, doesn't mean that Intuitive don't need to continue to drive that frontier forward, but it's still something we'll need to watch very closely.

KB: And we've obviously talked a lot about the challenges in the industry. It would be nice to finish on a positive note. So, Paul, what gives you the greatest reason for optimism in the medtech sphere today?

PL: Well, I think it goes back to what I, kind of, talked about at the start when really discussing why it's been an attractive area for us historically. And I think many of those real attractive characteristics are very much still in place. Those long-term structural tailwinds, you know, we don't see any, kind of, slowdown in innovation. Demographics are still aging. Emerging markets are still getting up the curve. So, there's still huge long-term growth in this space. So, all of those attractive characteristics are still in play. And when you have a very attractive sector that is, for understandable but hopefully transient reasons, very much out of favour, that should be quite a promising set-up, and that's certainly what our belief is today.

KB: Paul, thank you very much.

We've covered a lot of ground today from the headwinds facing the medtech sector to some of the innovations that are changing patient care. Paul, it's been great to get your thoughts on what's been happening in the sector recently and where the innovation lies ahead.

And to those of you who've tuned into this episode, thank you for your time. If you'd like to explore these themes further, the latest edition of the Walter Scott

Research Journal has an interview with a surgeon who uses Intuitive Surgical's robotics every day. It offers a first-hand insight into how this innovation really is changing healthcare.

Thank you once again for listening and we look forward to welcoming you back for the next episode of Talking Research.

WALTER SCOTT

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