



Suncoast Equity Management, Inc.

April 1, 2013

Dear Client:

SEM accounts kept pace with the market advance in the first quarter as SEM accounts advanced +9.9% versus +10.6% for the S&P 500. SEM's preferred ownership of businesses with strong earnings power is a key component of long-term outperformance of the general stock market. Changes to the portfolio were minimal in the first quarter so a few business updates detailed below will keep you current.

Long-Term Earnings Power

Our goal is to achieve above market investment results while taking less risk over the long-term. To achieve this goal we employ the **SEM-Disciplined Investment System** (SEM-DIS) to become part-owners of a small group of quality businesses. This strategy focuses on the long-term earnings power of a business in relation to the price we can buy it at. We utilize several mathematical equations to get a good understanding of the economic realities of the business and relative valuation. One of the most important is what we refer to as the "*Investor's Equation*." The concept of this equation has been around for hundreds of years if you consider the proverb "a bird in the hand is worth two in a bush," and it is well covered in a terrific book by the same name "The Investor's Equation" that I studied over 20 years ago.

The easiest way to first understand the investor's equation is to consider a bond, in which the annual earning (or interest) is fixed. A high quality twenty year corporate bond purchased today is yielding 3.5%. So if we invested \$100,000 and earned \$3,500 the value of our investment would grow to \$103,500 at the end of the first year. If we reinvest the principal and the earnings at the same rate it would take twenty years for our original investment to double and grow to \$200,000.

Suppose instead we buy a business and invest \$100,000. Assume the company has no debt and we will conclude that it is representative of the average publicly traded company that earns on average, after taxes, \$12,000 on the owners' equity of \$100,000. Let us further propose that assets (equipment etc.), depreciation and replacement are included in our profit figures. Finally, we are reasonably confident the business can earn a similar return on equity (ROE) of 12% (\$12,000/\$100,000) and earn the same return on reinvested earnings going forward. Below you can see how the company's value accumulates:

	<u>2013</u>	<u>2017 (5-Yr)</u>	<u>2022 (10-Yr)</u>	<u>2027 (15-Yr)</u>	<u>2032 (20- Yr)</u>
Owners' Equity	\$100,000	\$157,352	\$277,308	\$488,711	\$861,276

With 100% retention of earnings and a 12% reinvestment return, owners' equity grows to an amount considerably higher than an investment in the AAA quality corporate bond earning 3.5% that grows to only \$200,000 after twenty years.

Now that you can see how a bond and business compound differently, we need to introduce why at SEM we prefer businesses that earn above average returns on equity and how these companies support a higher valuation multiple. In the next table we present two companies, ABC and XYZ. Just like our above example company, XYZ represents the average business within the stock market and over the long run has earned about 12% ROE. Today the stock market, as represented by the S&P 500, is at 14.4x price-to-earnings (P/E). If a stock has a P/E of 14.4 then it has an earnings yield of 6.9% (E/P or 1/14.4). So for every \$100,000 we invest in XYZ we are getting \$6,900 in earnings. Company ABC earns a much higher ROE of 20% and is representative of SEM companies such as **Accenture**, **Grainger** and **Nike**. If we want to pursue the ownership of a higher ROE company, we usually have to pay a higher price. Today a P/E of approximately 20x (earnings yield of 5%, or \$5,000 per \$100,000 initial investment) is the going rate.

<u>Company</u>	Earnings in Year				
	<u>2013</u>	<u>2017 (5-Yr)</u>	<u>2022 (10-Yr)</u>	<u>2027 (15-Yr)</u>	<u>2032 (20-Yr)</u>
XYZ (12% ROE)	\$6,900	\$10,857	\$19,134	\$33,721	\$59,428
ABC (20% ROE)	\$5,000	\$10,368	\$25,799	\$64,196	\$159,740

As you can see from this table, when earnings streams compound at different ROE rates, the higher ROE company (ABC) records similar owner earnings levels up to the fifth year and then dramatically higher earnings levels further out. Higher earnings levels then lead to higher valuations:

	Implied Valuation/ Growth of \$100,000				
	<u>2013</u>	<u>2017 (5-Yr)</u>	<u>2022 (10-Yr)</u>	<u>2027 (15-Yr)</u>	<u>2032 (20-Yr)</u>
XYZ (12% ROE)	\$100,000	\$156,345	\$275,533	\$485,583	\$855,764
ABC (20% ROE)	\$100,000	\$207,360	\$515,978	\$1,283,918	\$3,194,800
20 Year AAA Corporate	\$100,000	\$118,770	\$141,060	\$167,530	\$200,000

If the businesses continue to have the same potential going forward as they did when we first invested in 2013, our original \$100,000 would grow to these levels over the various time periods we show above. You can see that we also included our original example of the 20-year corporate bond that if bought today yields 3.5% and would double in value in 20 years. You can see how much more valuable a high quality company becomes and how poorly bonds can do over the long run if the reinvestment rates stay constant.

While compounding occurs not only in fixed income investments but also in the retained earnings by business enterprises, businesses earnings are subject to fluctuations and not a fixed figure as it is with bonds. When we conduct our analysis of the numbers, several adjustments must be made. We will spare you all the details but one example will give you insight. If a company pays a common stock dividend then we need to adjust the ROE. The compounding factor we would use is the percentage of earnings retained times the ROE. So if a company pays out 40% of earnings, ROE for company ABC would be reduced to 12% or 20% ROE x 60% earnings retained. And then we would add back the dividend yield to arrive at the total return estimate.

In addition to understanding earnings power, the investor's equation illustrates that you don't simply compare price-to-earnings (P/E) ratios (or price to free cash flow) among the few thousand publicly traded companies and end your analysis there. ROE is a critical component as it provides an indication of the relative quality of the business and compound potential. It is the long-run interaction between the P/E ratio (valuation) and the return on equity (earnings potential) that is the driving force for value creation. So if Ford Motor is selling at 12x P/E and Grainger is selling at 20x P/E, Ford is not necessarily the better long term investment as more study is required.

One of Warren Buffett's earliest and most successful investments, See's Candies, is the poster-child for this process as well as his later investment in Coca-Cola. I highly recommend you take the time to do a Google search for Warren's comments on See's, especially those he has written in his annual letter to shareholders. Then you can clearly understand why his grin is ear-to-ear when he talks about this business and compounding earnings power.

The key question of course is can the earnings generated in the past year be reinvested and earn the same return or higher for the new-year and years into the future. Besides the financial history that gives us a sense as to the future probability that the business can continue on the same path, qualitative analysis takes over from here. This quarterly letter, as well as our previous letters, often shares our current thoughts about the qualitative characteristics that are important in assessing long-term earnings power. Those qualitative factors include the analysis and best judgment of a company's economic moat, product or service innovations, advantages of scale, etc. Lastly, we always strive to buy our above average businesses at a below market valuation to support our above average long term returns.

Portfolio Update

On the first day of the New Year we had **Abbott Labs**, a company we have owned for nearly five years, split into two separate entities. **AbbVie** (ABBV) is the new entity and encompasses the branded/prescription pharmaceuticals business. Meanwhile, legacy **Abbott Labs** (ABT) retains the devices, diagnostics, nutritionals and established pharmaceuticals. The key product for ABBV is Humira, addressing inflammatory conditions like rheumatoid arthritis, psoriasis and Crohn's disease. Humira is the world's single highest selling medicine at nearly \$9.3 billion in product sales in 2012, up 17% from the previous year. ABBV's near-term fortunes reside nearly all on Humira since it represents greater than 50% of sales and 70% of profits. The company is pursuing new indications for Humira as well as new medicines that could reach market about the same time when Humira faces U.S. patent expirations in 2016. One important observation at this time is the difference between biotech and chemical pharmaceuticals and the issue of patent expirations. Patent expirations weigh heavily on chemically based products because they are easy to copy such as Pfizer's Lipitor. Once copied, the price falls considerably and the earning power of Lipitor and Pfizer is permanently damaged. Biotech drugs, sourced from living cells, are nearly impossible to copy at this time and certainly more costly to try. Even batches made by the same manufacturer have slight variations. Copies of chemical based products are known as "generics" while attempts to copy biotech are referred to as "biosimilars." Recent reports indicate that development of a biosimilar can cost up to \$200 million versus a much lower cost of \$50 million for a chemical generic. Convincing doctors is another major hurdle at this time as recent reports indicate that some biosimilars, despite their lower cost of 25% or more, have not gained traction and garnered less than 10% of a market over uncertainty on just how close the outcomes and side effects between the copy and original will be over time for patients.

Humira's strength for Abbott and now for ABBV has been both a blessing and a curse, a phrase we often use with our companies that hold such strong market positions. Because of such strong profitability and market share, it will attract a lot of attention and competition from all angles. Manufacturers are not the only part of the supply chain angling to earn a piece of the large profits away from ABBV/Humira. Companies that distribute the product and manage the cost to the patients continue to apply pricing pressure. For the past five years we have been a beneficiary on the distribution side, as so many chemical based pharmaceuticals have gone generic, through our investment in **McKesson** and recently with **Express Scripts**. Generics have generally been more profitable for distributors versus branded pharmaceuticals. Pricing pressure on pharmaceutical manufacturers comes from great purchasing power on the distributor side due to consolidation, which continues at a fast pace. At the end of this quarter a proposed business deal between Amerisource Bergen (distributor) and Walgreen's (primarily a retailer) will reduce the number of independent suppliers to even fewer, in effect driving some large pharmaceutical companies to now test direct delivery of medicine to patients and cut out the distributor. At some point it can reach diseconomies of scale or the manufacturers could refuse to support lower economics. We will continue to watch the developments as it relates to ABBV and our related holdings.

The SEM-DIS discipline will opportunistically take advantage of stock market volatility, especially as it relates to a decline in price for one of our holdings based on headline news that ignore fundamental long-term thinking. One recent example is SEM's early June 2012 increase of **Google** (GOOG) in the \$570 price range. The stock fell to that level from the \$650 range when company news and investor worries that a shift in eyeballs to mobile from desktop computers would weaken the price of GOOG's advertising rates known as price per click. Over concerns such as the mobile screen is smaller so ads are harder to read and set-up and because the mobile space may have a competitor in Facebook, GOOG's stock declined. Instead, we looked at the longer-term view and what we saw fundamentally is GOOG's strength in digital advertising services spreading to new waterfronts. Our analysis concluded that strong digital advertising share, not just on their own page but for search and display ads on non-Google websites, would support the value proposal to mobile and other mediums still in development such as internet based TV, a wristwatch or GOOG glasses. The fact the pricing in mobile advertising may be a touch volatile and made short term investors nervous gave SEM an opportunity to increase our portfolio weighting at an opportune price.

Indiana, We're All For You!

Two closing thoughts for the quarter. It feels good to see my alma mater, the Indiana Hoosiers basketball team with coach Tom Crean, win the Big Ten after a 20 year drought and to have a good NCAA tournament experience in spite of the loss in the Sweet 16 round. Crean seems to be a very positive addition to a great University. Back when I was at Indiana twenty-five years ago, legendary coach Bob Knight brushed up against me as I was leaving the arena and asked me how my seats for the season looked. All I could muster was a soft reply of "not as good as yours" which garnered a smile from

a giant of a man. Coach Knight led the team to eleven Big Ten titles and three NCAA championships over his 29 year tenure that began back in 1971. A useful parallel I draw to investment management is that at least a few legendary coaches have remarkable coaching trees, Knight to coach Mike Kryzewski (Duke), Coach Dean Smith (North Carolina) to Roy Williams (North Carolina), Rick Pitino (Louisville) to Billy Donovan (Florida) and recent standout Andy Enfield (Florida Gulf Coast University), to identify the start of a few.

The direct tie to investment is that we consider ourselves part of the coaching tree started by Ben Graham and followed by Warren Buffett. There are others among us with solid investment records and what we share of course is common principles laid by these two great investors. Those of us that come from the intellectual village of Graham and Buffett, practice our own interpretation but stay within the margin of safety, just as these legendary college basketball coaches do.

Coach Knight has a new book “The Power of Negative Thinking - an unconventional approach to achieving positive results”. His point is that what comes from hoping for a good outcome (like a last minute shot bouncing off the rim and going in) is not the same as what comes from hard work (disciplined passing), and deep thought about how we become better. Not everything goes the right way so we should cherish what we learn from a thorough analysis of our mistakes. We connect with the coach on this level and we not only spend our time debating our companies’ (players) abilities but continually review our discipline for improvements, incremental or significant, and deeply believe that we can be better and that we never stop learning.

I plan to pick up a copy Knight’s recent book but since I’m a value investor I will likely wait for it to go on sale. We at Suncoast are only 15+ years into what we hope will be a 40 year season. Thanks for your continued confidence and we will keep working hard to preserve and grow your capital. We welcome your call anytime.

Sincerely,

Donald R. Jowdy
President

Suncoast Equity Management, Inc.

Performance results versus the Standard & Poor’s 500 Index

<u>Time Period</u>	<u>SEM % Return*</u>	<u>S&P 500 % Return</u>	<u>SEM - Value of \$1,000,000</u>	<u>S&P 500 - Value of \$1,000,000</u>
First Quarter 2013	+9.9%	+10.6%	\$ 1,099,000	\$ 1,106,100
One-Year	+11.9%	+13.9%	\$ 1,119,200	\$ 1,139,600
Three-Year	+11.6%	+12.7%	\$ 1,388,300	\$ 1,430,500
Five-Years	+6.3%	+5.8%	\$ 1,356,400	\$ 1,326,400
Seven-Years	+6.2%	+5.0%	\$ 1,526,000	\$ 1,408,000
Inception (15 ¼ Years)	+7.4%	+5.1%	\$ 2,983,300	\$ 2,132,700

* Composite results of all SEM managed accounts, net of all fees.

Note: Performance results for the three, five, seven and since inception year periods represent the annual average rates of return.