



## Suncoast Equity Management, Inc.

January 2, 2013

Dear Client:

The equity markets pulled back in the fourth quarter, driven it seemed by the negative sentiment for our government leaders. Notwithstanding, SEM clients and the market had a very good year with our composite return of +19.2% and +16% for the S&P 500. In the final seconds the “fiscal cliff” was averted; however, there is much work to do in Washington and important issues remain. Looking forward, we believe confidence will remain volatile but we should see an eventual shift in attention towards the improving economic growth trends. Our discipline remains intact and through it we are finding that our companies are executing well in some of the leading growth areas of the economy.

### **“Fiscal cliff” does not wag the “long-term” tail of the economic dog**

The standoff in the Capital clearly delays investment by businesses and dampens consumer confidence. Perhaps not to everyone’s personal preference, a budget accord and an action plan will be put in place in part or in whole as we enter the New Year. What is overlooked is that the economy has been recovering, albeit slowly, since mid 2009 from what was then a tremendous bubble and when it burst, it impacted us all. In the U.S. the economy is growing and we have seen important foundations of strength, such as housing and a return of offshore manufacturing back to the U.S. We will need to rebuild in the wake of monster storm Hurricane Sandy and we also see a path towards a new energy revolution in the U.S. These new energy discoveries and sources, especially shale gas, can lower energy costs in general and in particular for U.S. manufacturing. Meanwhile, the rest of the world needs some time to get back to growth as Europe’s economy is still slipping a bit and Asia is coming off strong growth rates.

The primary drivers of new growth always get lost in the headlines, especially in today’s flood of “fiscal cliff” chatter. It is our belief that the two most important forces are (1) major advances in technology and (2) the march forward of global freedom and education. Both are alive and well but not obvious. In part they are not obvious because we can’t always see the major impacts of technology until it is in the rearview mirror; examples such as the steam engine or microchip come to mind. So technology surprises us and is not predictable, but it is a terrific time for new developments, some of which we highlight below when we cover our companies. Citizens around the world are gaining greater access to education, freedom and protection. These factors motivate the human spirit to produce (and not just consume) new goods and services. The common belief is that competition from rising education is not good for the U.S. citizens, but indeed it leads to greater efficiencies and lower costs.

We hope that our government leaders will put together a budget plan that addresses important issues soon. Meanwhile, the economy has been improving for nearly three years and we are optimistic that the U.S. will, along with nations worldwide, grow over the next five to ten years.

### **SEM Investment Criteria put to work**

We don’t own a piece of the entire economy but rather we share in the profits of a small collection of businesses. Consequently we can continue to do well in spite of what may be a low growth environment for the economy. The criteria for investment selection, over our past fifteen years and for the future for the **SEM- Disciplined Investment System**, remains as:

- **Financial Performance & Strength**

Part owners of business that:

- a) Have a strong balance sheet and employ moderate to low debt
- b) Earn above average return on capital
- c) Generate excess and growing free cash flow

- **Business Track Record** – Emphasis on companies which have a consistent operating history.

- **Favorable Business Outlook and Opportunity** – Own businesses with sustainable advantages or franchises.

**Discovery Communications (DISCK)** has served us well in the short time in which we have been part-owners and we believe it has a bright future. DISCK's success is a result of creating non-fiction content (mostly science and adventure) that garners strong ratings and subscribers, which in turn leads to increased ad rates. At the same time, its programming costs are lower than competitors dealing with rising talent in a successful sitcom or ever-increasing sport production such as the costs of broadcasting the NFL. The stars of DISCK, such as the sharks of "Shark Week" or the Animal Planet's gators in "Gator Boys," don't demand higher payments. DISCK's content easily crosses borders as well. Propelled by pay-TV subscriber growth in Latin America and Asia, international revenue has grown to 36% of total. The recent acquisition of SBS Nordic with twelve TV networks in Norway, Sweden, Denmark and Finland will be interesting to observe. The content in these networks is more general and scripted and DISCK will likely improve the financial returns by swapping out this more expensive programming with its own. We label President and CEO David Zaslav as a wealth builder and look forward to having him lead a continuation of disciplined investment in properties with strong potential.

We have owned **Gilead Sciences (GILD)** for nearly four years as it accumulated profits from its market leading once-a-day HIV pill. Many investors lost interest, and stock declined in price at that time, because they were concerned that the company's growth would diminish. This year GILD put much of its excess cash and financial strength to work by successfully acquiring the company that is developing a novel treatment for Hepatitis C. With this new treatment, which has a higher cure rate, the market opportunity is significant. More than four million people have hepatitis C in the U.S. and the market is expected to be in excess of \$10 billion. With this acquisition, GILD is in the driver's seat to provide a better remedy for its patients and earn a solid return for us as shareholders. The company applied the benefits (cash flow) of its sustainable advantage in one product to build the same strength in a new product.

Although there is much global growth ahead in the smart phone market (and we talked about this in prior letters) our companies that benefit, including **Apple, Google** and **Qualcomm (QCOM)**, don't rest on their laurels. These companies are constantly innovating by investing their excess cash in research and development projects to spur new growth. QCOM, for example, believes it can improve the capacity of wireless networks by 1,000 times, a much needed solution given the spiking demand for data traffic over the air. As CEO Paul Jacobs recently explained, a base station that used to be a large piece of equipment sitting by the roadside is now going to be the size of deck of cards or smaller.

Sometimes these innovations lead to sustainable advantages that drive huge business success, especially when a network develops. One of the easiest examples of this to explain is **Visa's** huge success. Every time you use that credit card you are reinforcing the strength of a network. The more folks that utilize the network the higher the return on scale Visa benefits from. And more users of that particular network the harder it is for competition to dislodge it. Technology may be the enabler but it is the perceived value of the service or good by the consumer that makes a network flourish or fail. We are fortunate to have a few companies in our portfolio that benefit from the networking concept including Apple, Google and even **Berkshire Hathaway**. With Berkshire it has worked somewhat in reverse in which Buffett's opportunity to acquire good private businesses at attractive rates has been plentiful because many owners enjoy saying, "I have sold my company to Warren Buffett." For both the buyer and the seller, being under the umbrella of companies at Berkshire carries certain bragging rights.

The retail landscape continues to shift not just towards online but to more *mobile*, online shopping, as this past shopping season has demonstrated. ChannelAdvisor, a cloud based ecommerce solutions company, reported that for many popular shopping websites, mobile traffic represented around 30%-40% of holiday traffic levels, compared with 10%-20% of traffic during past non-holiday periods. **eBay**, one of our holdings, is a direct beneficiary. ChannelAdvisor added that on Cyber Monday third-party sales on eBay increased about 57% and its alternate payment solution company PayPal

increased volumes 200%. Some of the jump could be tagged as demand pulled forward by good shopping deals, but the direction is clear.

### Holiday Reminder

The trip home for the holidays is always an enjoyable time, though it was with heavy heart this year. Having grown up in the Northeast, and in particular the Danbury-Newtown Connecticut area, Hurricane Sandy and the elementary school tragedy bring about heart-breaking loss, emotional suffering and a personal connection. We are saddened by these events, though we embrace the touch of solace in reading the many stories of global support for these communities that will need time to rebuild and heal as best is possible.

Being human we can be inspired by negative and positive events. During my family visit, (they are now relocated to New Hampshire), this holiday and other client visits and discussions at year-end, we encounter firsthand what makes us tick at SEM. It is our passion to preserve and grow our clients' capital. We know that our clients count on us to support a child's education, or further down the line support living needs when a child chooses a noble profession that is undervalued such as teaching or as a first responder. We also derive satisfaction when one-on-one visits reveal parents content in retirement. These visits are our inspiration, along with the many client family photos we proudly display in our office.

The **SEM-DIS** and the high quality businesses in our portfolio will keep working hard to grow and preserve your capital, while taking less risk than the market in general. We thank you for your confidence and for the fifteen years of motivation. We look forward to the next fifteen and beyond. Best wishes to all for a peaceful and successful 2013.

Sincerely,

Donald R. Jowdy  
President

### *Suncoast Equity Management, Inc.*

Performance results versus the Standard & Poor's 500 Index

| <u>Time Period</u>   | <u>SEM<br/>% Return*</u> | <u>S&amp;P 500<br/>% Return</u> | <u>SEM - Value<br/>of \$1,000,000</u> | <u>S&amp;P 500 - Value<br/>of \$1,000,000</u> |
|----------------------|--------------------------|---------------------------------|---------------------------------------|---|
| One Year 2012        | +19.2%                   | +16.0%                          | \$ 1,192,400                          | \$ 1,160,000                                  |
| Three-Year           | +10.0%                   | +10.9%                          | \$ 1,328,900                          | \$ 1,363,000                                  |
| Five-Years           | +3.0%                    | +1.7%                           | \$ 1,158,800                          | \$ 1,085,900                                  |
| Inception (15 Years) | +6.9%                    | +4.5%                           | \$ 2,714,500                          | \$ 1,928,200                                  |

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

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