Suncoast Equity Management, Inc.

July 2, 2015

Dear Client:

The equity markets tried to add to earlier gains, even in the face of the near term pressure on earnings and first quarter GDP contraction, but took a hit from concerns over Greece in the final days of the quarter. As we mentioned in our first quarter letter, Suncoast's relative results may shine since we own twenty or so high quality companies rather than the entire market (as some index funds do). Earnings growth expectations for 2015 for the SEM portfolio is still holding in the low double-digits range, which is tracking meaningfully above the low single-digit earnings growth for the market overall. SEM portfolio composite closed the first half +4.5% versus +1.2% for the S&P 500. We share some thoughts about the importance of capital allocation at the company level.

Capital Allocation

Excess cash generation is one of the most important qualities we look for in a business. As such, we closely study how management allocates this excess cash to determine if it enhances, maintains or erodes its competitive position. Capital allocation of excess cash can take many paths including (1) from the balance sheet, investment in working capital such as more inventory, (2) from the income statement, investment in research and development to create new products or services, or in marketing to drive sales (3) from the cash flow statement, investments in capital equipment or locations, or to fund acquisitions, and (4) finally return of capital to shareholders including payments of dividends and stock buybacks.

In an environment of low interest rates and low cost of capital, we are seeing a lot of businesses allocate capital towards acquisitions. Acquisitions can be quite revealing. When announced, we look foremost at whether management overpaid or got a fair deal and what impact it has on the post financial condition of the balance sheet. Second, we judge whether the acquisition adds to the economic moat or if it may have been done out of competitive weakness. We especially follow acquisitions to understand if they allow a business to better serve its satisfied clients or if it is trying to follow where their clients are heading because its products and services have lost their appeal. Over our twenty-five year plus span of investment analysis, we have seen many scenarios and this experience and perspective allows us to quickly conclude if the situation is value-enhancing or possibly value-destroying.

Disney (DIS) is a great example. In Bob Iger's 10 year history as CEO, he has time and again shown his ability to allocate capital well through acquisitions. In 2006 DIS acquired Pixar for $7.4 billion, not only rejuvenating its animation division with hits like Toy Story and Finding Nemo, but making Steve Jobs a business partner and Disney's largest shareholder. With the $4 billion acquisition of Marvel in 2009, Disney has been able to make progressively more with each sequel like Captain America, The Winter Soldier, and The Avengers which alone generated a phenomenal $1.5 billion in global ticket sales. Lucas film was acquired in 2012, owner of the Star Wars franchise. The trailer of The Force Awakens, which is due out this December, has already posted 200 million views and appears to be well on its way to setting a new record. The beauty of Disney's business model is the company's ability to leverage its business units. Hit movies are used to sell more consumer products, launch new attractions, draw visitors to its parks and cruise lines, etc. All of these factors allow us to conclude the acquisitions have created value for Disney.

McKesson (MCK), the largest drug distributor, is another example. In the last few years, MCK has acquired US Oncology (nation's largest network of community-based oncology practices), PSS World Medical (distributor of medical supplies, equipment, and diagnostic tests), and most recently Celesio (European drug distributor and retailer that supplies 65,000 pharmacies and hospitals). With Celesio, McKesson significantly increases its scale in outsourcing generic drugs from $6-7 billion to $10 billion. We expect the economies of scale to give MCK pricing power with its suppliers and ultimately boost margins. In our view, CEO John Hammergren has allocated capital well by acquiring businesses that leverage the company's core franchise.

We keep a close eye on the developments of 500+ companies that meet our stringent financial strength criteria but that we don't own, essentially our prospect list. One of these we believe engaged in a recent acquisition out of inherent need or competitive weakness. About a month ago Intel (INTC) announced it will acquire Altera (ALTR) for nearly $17 billion. ALTR and rival Xilinx make programmable chips which help speed up servers which INTC provides the basic processing chips for. It seems INTC needs ALTR. INTC can create custom chips for its customers but this gets expensive. So the remedy for the customer is to add on the programmable chips from ALTR and Xilinx. INTC, instead of innovating and creating a new product to meet its client needs, is essentially forced to make the acquisition. At the same time INTC needs to protect against a potential decline in sales of its core product (server chips). The price INTC is paying seems rich as well. Sales growth at ALTR has been flat since 2011. If ALTR can get back to peak sales in 2016, after a 10% estimated decline for this year, and maintain recent margins which may be challenging, it could potentially see ALTR's business generate $500 million in free cash flow. At that level it implies INTC paid 33.4 times free cash flow, rich indeed.

Acquisitions are not the only area we look at for clues of effective capital allocation. Take for example a recent comparison of spending efforts by **Nike** (NKE) versus Adidas. Nike and fast growing Under Armour (UA) have been winning more clients and market share while Adidas is lagging. NKE recently flexed its financial strength by taking over the rights to outfit the National Basketball Association (NBA) in an eight year contract costing more than $1 billion, effectively replacing Adidas' previous eleven year contract at a cost of $400 million. Separately Adidas put on a glitzy show at New York's Fashion week earlier this year, introducing an expansion into the hip-hop market with a Kanye West Adidas "Yeezy boost". This boot sold out the first run of 9,000 pairs for $350 each within minutes. So before we dig in, your first reaction may be "sounds like Nike paid a big number, especially for a shorter time period, and Adidas has got a great new product going on." Our analysis would conclude the opposite. As more folks trade casual attire for sportswear, activewear, or "athleisure" as it's called, it is one of the fastest growing categories within the apparel and footwear markets on a global basis. This consumer preference is one of the supporting reasons why we own NKE and **Hanesbrands** (HBI)**.** Yet higher demand for NKE's products is being driven by the company's intense strategic focus on research and development, which creates innovations such as the fly-knit athletic shoe platform, as well as marketing spend to satisfy the appetite of athletes of all lifestyles and backgrounds. On the other hand Adidas' recent effort may signal it is grasping at spurring fleeting demand by conjuring up fashion hits (think Crocs). NKE controls over 90% of the basketball footwear market, and is closing in fast on Adidas' 39% share of the global soccer market. The $1 billion NKE will spend on the NBA contract (without getting into the specific benefits of the new contract such as NKE's ability to display its logo on the uniform, a first for the league) could not be matched by either Adidas or fast growing Under Armour. Adidas' annual sales volume of $16 billion and Under Armour's sales of $4 billion are significantly less than NKE's $30 billion in sales. Even with fast growth at UA, it would have to give up more than 50% of its current net income run rate just to cover the NKE NBA annual contract cost of approximately $125 million. NKE's global scale is unmatched at present, though we will keep an eye on its very hungry and capable competitors.

<u>Summer Thoughts</u>

The economy could use a boost going forward, in spite of the experience for many households and businesses that they have become stronger since 2009. Economic growth in real terms is averaging a low 2.2% annual rate in the twenty-three quarters since the recession trough in June 2009, as observed by Glenn Hubbard, Dean of Columbia Business School. He further adds that the U.S. has experienced the weakest expansion since World War II and the country is in the midst of the worst five-year run for productivity ever measured outside a recession. With productivity down, the ability for most publicly traded companies to drive the bottom line higher, in a muted revenue growth environment through alternate tools such as stock buybacks, runs out of runway quickly. As we approach the elections it would be helpful to put our support behind those leaders that can understand the economic underperformance environment that we are in. We could use a boost from policies that can enhance growth such as tax reform and lower tax rates, as well as trade improvements to broaden the participation and achieve growth closer to 4%. So keep this in mind as you review the slate of candidates. We thank you for your continued confidence as we invest alongside you in the same portfolio and strive for positive performance.

Sincerely,

Don *Amy*

Donald R. Jowdy
President

Amy Lord, CFA
Senior Vice President

Suncoast Equity Management, Inc.

Performance results versus the Standard & Poor's 500 Index

Time Period	SEM % Return*	S&P 500 % Return	SEM - Value of $1,000,000	S&P 500 - Value of $1,000,000
First Half 2015	+4.5%	+1.2%	$ 1,045,100	$ 1,012,300
One-Year	+13.4%	+7.4%	$1,133,900	$1,074,200
Three-Year	+19.0%	+17.3%	$ 1,684,000	$ 1,614,300
Five-Years	+17.5%	+17.3%	$ 2,239,700	$ 2,224,700
Seven-Years	+11.3%	+9.4%	$ 2,113,600	$1,878,400
Ten-Years	+8.2%	+7.9%	$ 2,202,400	$ 2,137,700
Fifteen-Years	+6.3%	+4.4%	$ 2,501,800	$ 1,895,800
Inception (17 1/2 Years)	***+8.6%***	***+6.4%***	***$4,251,900***	***$ 2,937,900***

* Composite results of all SEM managed accounts, net of all fees.
Note: Performance for the three, five, seven, ten, fifteen and since inception year periods represent the annual average rates of return