SUNCOAST EQUITY MANAGEMENT, LLC

January 2, 2017

Dear Client:

In the post-election run of optimism, the market surged to finish the year +11.9%. Our Suncoast portfolio got left behind as we were -2.9% in 2016. The market had a most unusual year in which news rather than fundamentals captured investor attention, especially in the final 50 days of the year. The Trump inspired rally "voted" in favor of domestic infrastructure, energy and financial stocks and became leery of businesses that benefit from global demand (exports) and immigration.

We have a terrific collection of businesses squarely positioned in some of the fastest growing areas of the economy in the United States and globally, including digital advertising (**Google**, **Facebook**), payments (**MasterCard**, **Visa**, **PayPal**), digital commerce consulting (**Accenture**, **Cognizant**) and homebuilding and improvements (**Lowe's**, **Middleby**). We are very confident in the long term appreciation potential of our businesses and consequently our portfolio. Its valuation is attractive relative to the market due to the lag in appreciation.

Lifetime success in investing is achieved from a long term view. It is a *marathon* not a *sprint*, like we recently witnessed post election to year end. We faced a similar circumstance versus the S&P 500 in 2005-2006 and overcame that gap within the next two years. Since SEM's inception, $1 million has grown to $4.1 million net of fees versus $3.3 million in the index (no fees considered). We plan to build upon that value added over the next decade and beyond.

The proper framework for investment success involves seeking out and owning wonderful businesses at reasonable prices and letting those companies generate and compound cash over long stretches. We discuss below how we identify above average businesses that have led to our outperformance since inception. Then we take you through the categories of companies that caught post election euphoria and why they don't meet our criteria for long term wealth builders.

Long Term Ownership in Economic Moats and the Importance of Return on Capital

The market indexes such as the S&P 500 (which has 500 stocks) are comprised of a wide variety of companies; a virtual mixed bag of businesses, some with weak competitive positions and others with strong positions in their industry or the economy as a whole. We intentionally don't own the market since the indexes are made up of a wide range of businesses and as such, SEM can be minimally correlated with any given calendar year return, as it was in 2016.

One of our key beliefs is that economic moats drive value long term. Economic moats are positive structural characteristics that persist for a number of years and are hard for competitors to replicate. They come in many forms like economies of scale, a brand name, a patent, or even a "network effect" where the value of a company's product or service increases with each new user.

It is common sense to believe that some businesses are simply better than others. But what data should you begin with to support your premise and differentiate among them? Return on capital (ROC) is one of the best indicators to make this judgement and it is an important measure of a company's profitability. ROC tells us how effectively a company uses its assets – inventory, research and development, factories and equipment, marketing and people – to make money for shareholders. Since the average business in the S&P 500 generates a 9% return on capital, that implies there are companies in the S&P that generate returns below 9%, as well as at and above 9%. We start by looking at companies with little or no debt that consistently generate free cash flow and high ROC.

If our fundamental analysis leads us to believe the company has an economic moat that will allow it to keep generating high ROC, then it becomes a candidate for our portfolio. Although all of our holdings generate above average ROC, we have highlighted a few below and our ownership history:

	ROC	**Purchase Date**	**Average Initial Cost**	**Current Price**	**Gain Since Ownership**
Accenture	45%	July 30,2009	$35.23	$117.13	232%
Alphabet (Google)	15%	Sep. 8, 2008	$223.60	$792.45	254%
Nike	27%	Mar. 1, 2006	$10.83	$50.83	369%
Priceline	20%	May 13,2014	$1,160.59	$1,466.06	26%

In our view, it's no coincidence these businesses have produced better than average appreciation over the years. The success of companies with economic moats and high ROC is more evident over longer holding periods, and consequently reflected in our above market results since our inception.

Portfolio Update

Following solid earnings reports, we increased our weightings in **C.R. Bard (BCR)** and **Middleby (MIDD)** with the proceeds from the sale of one of our long term successful holdings, **McKesson (MCK)**.

BCR develops and sells medical supplies globally for oncology, vascular, urology and surgical treatments. China and Japan offer significant opportunities for growth and margins should increase due to cost improvements and mix. Also BCR expects to launch its new drug-coated balloon in late 2017, Lutonix, which could give revenues and earnings a boost. MIDD, which sells innovative equipment for commercial and residential kitchens, as well as food processing, is expanding globally. Its products help its customers save labor, energy, water and waste. Margins are on track to increase due to recent acquisitions and new product rollouts.

MCK was first purchased in 2008 and increased in 2009 for an average purchase price of $41. The business drivers were an aging population, innovation, and economies of scale. At that time the pharmaceutical industry was shifting from branded to more generics, which offer higher margins for the drug wholesalers. During our ownership, operating margins grew 50% from 1.5% to 2.3%. Early in 2016, MCK announced generic pricing was no longer a tailwind and that they had lost some clients due to industry consolidation (diseconomies of scale). We reduced our position. In October, MCK stated a competitor had launched a price war and McKesson was forced to match the lower pricing or lose clients. When price wars occur we can't determine how long it will last. Like the cereal companies' price war of the 1980s, it may signal that pricing power has been lost for the foreseeable future. As a result, we sold our remaining position for an average sell price of $144.

Trump's 50+ Days of Amazing Hope! Back to the "Voting" Machine!

Energy, infrastructure, materials and financials, driven by the hope of the new president-elect, powered the market in the last 50+ days of the calendar year as these stocks as a group were up more than 20% in 2016. Following February's drop to a bottom in oil and the surprise vote of Brexit, sentiment in the U.S. shifted from pessimism to optimism. Market participants bid up any stock tangentially connected with Trump's potential policy direction and panned those benefitting from global growth or immigration on the speculation they would be hurt by less friendly trade agreements. As markets have done in the past, will do in the future, and may be doing now, the current optimism may have gotten ahead of itself in the categories of energy, infrastructure, materials and financials.

A historical perspective is a good place to start. Long considered the father of value investing and mentor to Warren Buffett, Benjamin Graham was a British born economist and professional investor. Among his great achievements was that he taught at Columbia in 1928 and authored *Security Analysis* with David Dodd. Graham's ability to simplify the proper framework for investing came in many examples including this quote: *"Investment is most intelligent when it is most businesslike."* One of his greatest summations is "*in the short run the market is a voting machine but in the long run it is a weighing machine.*"

If Graham were alive today we believe he would comment that 2016, and especially since the election, the market has seen one of the greatest occurrences in recent times of the "voting machine." So what is behind this statement and how can history help us? Graham believed as do we, that in the short run the market can be completely driven by the investing public's emotions with significant disregard for fundamentals. The "voting machine" can be minor or major in its journey. Some examples from our experience may help. The "voting machine" often occurs when a hurricane approaches Florida. Almost on cue, the stocks of Lowe's, Home Depot and Wal-Mart artificially go up in advance of a storm as investors believe these companies will reap a huge reward from selling generators, lumber and various supplies. But inevitably the stocks decline back to their pre-hurricane levels once the storm hits, realizing it was only a temporary boost in business volume at best. Geopolitical events such as terrorist attacks, often come with human suffering that temporarily sours the mood of investors. But the market always bounces back, oftentimes in less than a month. A more dramatic example of the "voting machine" was in the fall of 1990 when the market fell 20% due to anticipation of the Gulf War. However almost immediately following the first shots in early 1991, the market returned to its previous levels.

On the other side of Graham's statement is that over the long run the market "weighs" the substance of the business; it is the actual underlying business performance that matters over time and is reflective in the share price. When a business performs well the stock will do well; when the business erodes so will the stock. During our ten year ownership of **Nike (NKE)**, the company has grown its earnings from $1.4 billion to $3.8 billion. As noted in the above table, the stock has increased from our cost of about $11 per share to $51 **-** a very nice gain. Compare that to **U.S. Steel** (X) which reported net earnings losses in seven of the last ten years and whose stock price was at a midpoint of $98 in 2007, but is $33 today. Clearly the "weighing" machine is reflecting the fundamentals of the business over time.

So in observing the post election action in the market, we put together the following data:

	Price Performance								
	2016	Post Election	From All Time High	Earnings Peak	Year	Earnings 2016e	% Change From Peak	Earnings Est. 2019-2021	% Change From Peak
S&P 500*	10%	7%	-2%						
SEM	-3%	1%	-8%	7/20/2015					
Energy									
Chevron**	31%	10%	-13%	$26,895	2011	$380	-99%	$18,500	-31%
Exxon**	16%	6%	-14%	$45,220	2008	$9,200	-80%	$35,500	-21%
Infrastructure/Industrial									
Caterpillar**	36%	11%	-21%	$6,270	2012	$1,975	-69%	$3,775	-40%
Deere & Co	35%	29%	-2%	$3,533	2013	$1,440	-59%	$2,190	-38%
Financials									
Bank of America	31%	30%	-60%	$21,133	2006	$17,500	-17%	$22,100	5%
Goldman Sachs**	33%	32%	-4%	$13,385	2009	$6,850	-49%	$10,795	-19%
Wells Fargo	1%	21%	-6%	$23,057	2014	$20,320	-12%	$27,300	18%
SEM									
Alphabet (Google)	2%	-1%	-5%	$21,750	2016	$21,750	0%	$35,550	63%
Hanesbrands	-27%	-11%	-31%	$730	2016	$730	0%	$1,045	43%
Nike**	-19%	0%	-25%	$3,760	2016	$3,760	0%	$5,655	50%
Priceline	15%	-1%	-8%	$3,425	2016	$3,425	0%	$6,000	75%
Visa**	1%	-5%	-7%	$6,328	2015	$5,991	-5%	$11,250	78%

* - Prices for the index and for individual stocks excludes dividends for the purpose of this table and reflect price change only

** - Indicates member of the Dow Jones Industrial Average

The table shows the "voting machine" at work with market participants' favorite categories of 2016, and prominent companies within them. The categories and stocks which are up 20%+in the short period following the election have mostly risen in the midst of a major earnings decline.

Energy stocks have had a very good year since the price of oil doubled off its low in February. Yet in spite of the improvement in price, energy companies will experience major earnings declines this year; Chevron's earnings may be down 99% from its peak in 2011. While difficult to forecast because they are so dependent on the price of oil which they can't control, *Value Line* earnings estimates for **CVX** and **XOM** suggest they may only get back to two-thirds of peak earnings posted in 2008 and 2011, in the next few years. Energy companies have never passed the strict requirements of **SEM-DIS** and as such have not been in our portfolio. Their disadvantage is that they are capital intensive businesses and their cost to grow or reinvest back into their business fluctuates unpredictably with the price of oil. We require that our businesses consistently generate cash in excess of their operating costs and capital expenditures. Energy companies often fail this margin of safety hurdle.

Infrastructure stocks have had a quick and upward run post election. The hope is that policies will be approved to rebuild our roads and highway systems. We highlight two examples here, **Caterpillar** (CAT) and **Deere** (DE). DE is amazingly at its all time high, yet its 2016 earnings will be -60% from their peak in 2013. *Value Line* estimates that earnings will still be -40% below their peak in 2020. We have chosen not to invest in deeply cyclical companies such as DE and CAT, since ROC can fluctuate wildly during the business cycle. Other companies in this sector that have soared are **Vulcan Materials (VMC)** and **Martin Marietta Materials (MLM),** which often have inventory and working capital issues during the cycle. We do own and have had success with industrial companies like **Honeywell (HON**), because it earns an above average ROC and has a more steady earnings profile.

Banks and many financials soared post election as the jump in yields signaled expectations that 35 years of interest rate declines may have ended. The ten year U.S. Treasury yield surged to 2.6%, after hitting a record low of 1.37% in July. The bottoming of rates may signal an end to concerns of global deflation which can be very bad for banks that lend on assets values. Banks are also more profitable when they borrow at low rates and lend at higher rates. One problem here is globally rates are still very low, as well as negative in places like Germany, Japan and Switzerland. So uncertainty and challenges remain. Banks may continue to improve if rates rise slowly, but we have passed on investing in this group as we are never comfortable that we can assess the risk in the loan portfolios, especially when economic slowdowns occur. We like to own businesses throughout the business cycle rather than "timing" the purchase or sale within a cycle. What is important to us when slowdowns occur is that our businesses have the financial strength to take advantage of buying a competitor or buying back their own stock at a good value. Most of the time banks are just trying to survive during recessions like we had in 2008-2009.

We also added SEM stocks to this table confirming what you already know, that their stock prices have been flat to down this calendar year. The most startling observation occurs when you look at the far right column showing *Value Line's* projected growth in earnings for our companies at 40%+ versus the mostly negative (off peak) to slight increases for the energy, infrastructure and financial groups as discussed. The clear and present takeaway from this data is that our companies are growing their intrinsic value while the stocks in the energy, infrastructure and financials that carried the market performance in 2016, are struggling to grow. Over time we have every confidence that the "weighing" machine will fix this temporary scenario and SEM's investment performance will reflect the business performance of the companies we own.

Thinking Ahead

The underlying feeling of confidence of the new president-elect and his administration is a big positive. It is healthy to see the widespread optimism and positive attitude from business leaders that supported Trump early on, such as Ken Lagone founder of Home Depot, and previous non-supporters, such as Howard Schultz of Starbucks. We would like to see the follow through that will put political beliefs aside and work to help the new administration improve our country. For sure we believe in the power of positive thinking as economic optimism surged to its highest level in 7 years in a mid December poll conducted by CNBC (800 Americans were surveyed from diverse income and economic backgrounds). We do see a lot more moving parts ahead for the "voting machine" to digest, be it potentially negative like international relations and nuclear policy or positive like corporate tax reform.

One final thought, could the rather aggressive rise in energy, infrastructure and financial companies' valuations be signaling some unforeseen pickup in economic growth ahead? It's possible, but unnecessary for us to forecast to be successful. We would certainly welcome it if earnings projections for all the companies in the table prove conservative. If the stock prices for those businesses that carried the market in 2016 cool off, we feel equally confident in SEM's relative value and long term performance. Our intrinsic values continue to grow as we remain positioned in some of the fastest growing parts of the global economy.

Thanks as always for your support and best wishes for a healthy, prosperous and peaceful 2017!

Sincerely,

Don *Amy*

Donald R. Jowdy
President

Amy Lord, CFA
Senior Vice President

Suncoast Equity Management, LLC

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**
One-Year (2016)	-2.9%	+11.9%	$ 970,500	$ 1,119,600
Three-Year	+3.5%	+8.9%	$ 1,109,300	$ 1,290,500
Five-Years	+12.5%	+14.7%	$ 1,801,300	$ 1,981,800
Ten-Years	+6.8%	+6.9%	$ 1,927,900	$ 1,957,200
Inception (19 Years)	***+7.7%***	***+6.5%***	***$ 4,100,700***	***$ 3,294,300***

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

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