Suncoast Equity Management, Inc.

April 1, 2014

Dear Client:

SEM fell slightly as our accounts declined 0.6% versus a 1.8% gain for the S&P 500. At the end of the quarter a few of our holdings felt a tremor at the surface level. More importantly, the mantle and core of those businesses remain rock solid. We are confident in our ability to outperform the general market over the long term while taking less risk, which we have done for the past 16 years (see chart enclosed). We set out to reach this goal by being part-owners in a small collection of high quality businesses with strong earnings power. We strive to reduce risk by implementing a "margin of safety."

<u>Tremors Du Jour</u>

Going back to the Benjamin Graham well one more time, another intelligent observation he shared was that in the short run the stock market is a "voting" machine and in the long run it is a "weighing" machine. The translation is that in the long run if you own a company that posts a steady increase in earnings its stock price will also steadily rise. Conversely, if you own a company that never grows its earnings but rather the level bounces around a lot or if earnings decline over the long term, so will the stock price. In the short run, stock prices will almost always be volatile and may reflect only that which is popular, or unpopular, among market participants. A few of our companies experienced this "voting" environment right at the end of the quarter so we thought we would share two examples and our thoughts with you.

The crowd can move in a hurry and in the month of March they seem to have become disenchanted with Biotech and consequently one of our portfolio holdings, **Gilead Sciences** (GILD). The recent "voting" dislike for biotech can be seen in the recent and quick 10% decline in the iShares Nasdaq Biotech exchange traded fund (symbol: IBB). GILD represents nearly 8% of IBB, so if folks want to sell this index for any reason, it impacts GILD. GILD is undergoing the initial stages of the launch of Solvaldi, an important new product approved late last year to help those that suffer from hepatitis C, a virus infecting an estimated 3.2 million people in the U.S and more than 170 million worldwide according to the CDC. Prior treatments for hepatitis C cure less than 50%, involve injections of interferon over a period of 48 weeks and cost in a range of $60,000-$90,000. Solvaldi pricing is set around $84,000 with a much shorter duration of twelve weeks and it boasts a cure rate of over 90%. GILD has first mover advantage with its new drug and the impressive data will make it difficult to compete against; though we recognize that GILD could face some challenges from new offerings from **Abbvie** (another portfolio holding) and Bristol Myers, later this year. With healthcare a hot topic, anytime a new biotech product launches, no matter the improvement in cure rates or side affects, you get politicians complaining about the price. While we continue to observe its exciting progress and challenges, GILD could potentially capture half the global market for hepatitis C treatment by 2015. Financially speaking, it could translate into revenue of $10 billion, thereby effectively doubling total company sales volume in less than two years, and boosting earnings per share to the mid $5 range. That would imply a price-to-earnings ratio at today's price of 12.8 times (earnings yield of 7.8%), a very reasonable valuation.

Nike gave us a business and quarterly earnings update in the latter part of March and while the report and outlook was solid, the stock price declined by about 10%. The report from NKE highlighted some short term pressures such as currency headwinds and increased spending, but nothing that implies a permanent trend. The company continues to expand its Flyknit line of footwear with its launch into football and basketball. This new developmental method, which we have mentioned in previous letters, will potentially lower production costs while it currently creates new excitement for customers via new designs, more custom personalization and shorter delivery times. NKE's overall strengths of brand loyalty, global distribution and advantages of scale continue to widen. NKE is a great business to be a part owner in, even if its current valuation is in-line with our intrinsic valuation estimate, since we will benefit from the growth in the years to come. Compared with other choices in our "safety" company universe, it remains one of the best due to qualitative characteristics mentioned above and a projected operating earnings growth rate in the high single digit to low teens range, which is nearly two times what we see elsewhere.

<u>Margin of Safety</u>

Legendary investor and teacher Ben Graham coined the term “margin of safety” (MOS). For us “margin of safety” is not just a famous slogan but a worthy pursuit when trying to preserve and grow capital. We thought you might be interested in hearing how important this is and how we implement the concept of MOS into our investment process. At the forefront is the reality that businesses are faced with challenges as consumer preferences can shift, technology can advance, prices of product and services can swing and new competitors can emerge. Furthermore, businesses will experience events that are not always predictable. With the **SEM-Disciplined Investment System** (SEM-DIS) we can implement a process that minimizes the impact of those business event surprises, understanding that we don’t have to be right every time to be successful . Ben Graham instructed that each investment you make should possess a MOS, yet he further emphasized that MOS doesn’t guarantee a successful investment; it merely provides room for error. MOS is a very important concept and it plays a key role in each component of the SEM-DIS. We only consider companies that meet the following criteria and harbor these MOS characteristics:

I. <u>Businesses with consistent track records</u>
The MOS analysis here is if a company such as **Nike** has consistently achieved high returns on equity for a long period of time then it is reasonable to expect that the same good results will continue in the future. Likewise for the opposite, if International Paper has a long history of earning low returns on equity then that will likely continue into the future.

II. <u>Businesses which earn an abundance of free cash flow</u>
Companies that we own, for example **W.W. Grainger,** year-in and year-out produce excess free cash flow that accumulates and builds financial strength and MOS. This excess cash positions the company to fund growth initiatives such as expansion into new markets and investments in research and development of new products.

III. <u>Businesses with low debt to total capital</u>
A strong balance sheet is itself a MOS. Companies with low debt to total capital have certain advantages, especially during general economic downturns. They can prudently add debt to take advantage of a business opportunity such as buying a competitor or complementary business.

IV. <u>Businesses we understand</u>
Sticking with businesses we understand is an important factor for reducing the opportunity of a permanent loss of capital. This is otherwise known as staying within our “circle of competence.” We have never owned banks and companies in the energy field because our depth of knowledge in these areas is not deep. Companies in these industries have also typically fallen short of the financial criteria we look for. Most would believe that an investor needs to be knowledgeable about every business that exists, when in fact successful investing only requires you to be generally right about the businesses that you own.

V. <u>Businesses that we can buy at a reasonable price</u>
One additional measure of the MOS is the difference between the stock price and the intrinsic value of a business. The lower the stock price is relative to an estimate of intrinsic value, the greater the margin of safety. Since our preference is for growth businesses and intrinsic value is typically on a steady upward path, our effort is to identify companies whose prices don’t reflect their long term potential. Valuation also involves relative MOS between alternate asset classes such as fixed income. We will compare the yield on 10 year bonds offered by our companies against the earnings yield of their common stock. Currently, and in spite of the recent rise of the equity market, high quality equities are a better value than high quality corporate bonds.

Happy Spring to all, especially those up north who endured a tough winter. Like the difficult times we experienced recently in 2008-2009, harsh weather will end and flowers will soon bloom. We will always encounter various cycles that we need to endure but staying in the saddle long term has always been what is best. Thank you for your confidence and as we like to mention from time to time, we are right there with you; we eat our own cooking and our investments results mirror yours. We welcome your call anytime.

Sincerely,

Donald R. Jowdy, 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 Quarter 2014	-0.6%	+1.8%	$ 993,600	$ 1,018,100
One-Year	+23.1%	+21.8%	$ 1,231,100	$ 1,218,600
Three-Year	+17.9%	+14.6%	$ 1,639,000	$ 1,507,300
Five-Years	+19.8%	+21.1%	$ 2,473,500	$ 2,610,600
Seven-Years	+8.3%	+6.3%	$ 1,746,600	$ 1,534,200
Ten Years	+7.3%	+7.4%	$ 2,030,000	$ 2,045,200
Inception (16 ¼ Years)	+8.3%	+6.0%	$ 3,672,800	$ 2,598,900

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

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