Suncoast Equity Management, Inc.

July 1, 2013

Dear Client:

The Federal Reserve's recent statement that it could start winding down the bond buying program at the end of the year, mildly deflated the equities markets from all-time highs achieved earlier in May. Through the first half of the year, SEM accounts are +13% versus +13.8% for the S&P 500. While the monetary stimulus resulted in record low interest rates and supported higher bond and equity pricing, we don't believe the equity market is frothy, especially as companies move earnings to higher levels. As we discuss our preference for growth businesses, we bid farewell (for now) to one company and welcomed a new business to our portfolio in the quarter. As interest rates head back to normal levels, bondholders could face a great deal of heartburn and investment loss which we put in perspective below.

Quality, Growth and Value

Growth prospects are one part of gauging value. Of course the **SEM-Disciplined Investment System** (SEM-DIS) begins with quality as we only review and become part-owners of companies with strong balance sheets, a history of earning high returns on capital, and generating excess free cash flow. When we turn to the subject of growth, often investors can under appreciate the future and will hastily conclude that the stock is somewhat pricey from a valuation perspective.

Our ownership in **eBay** is a good example of this. The stock price is selling at a premium to the average company in the S&P 500, so many investors simply pass on looking underneath the hood. We believe the company's growth rate will significantly exceed the earnings growth rate of the average company for some years ahead. eBay is a global hub facilitating commerce through its main business divisions, eBay marketplace, eBay enterprise (formerly GSI commerce) and the PayPal payments division. The company is benefitting from a structural shift in retail to multichannel distribution, especially online and mobile. Clients of eBay enterprise, the business that helps with fulfillment, customer management, digital marketing and web stores, include Dick's Sporting Goods, Mattel and Godiva. At both the eBay marketplace and PayPal payments division, the company's user base is expanding both organically and through company investments. In the payments processing side of the business, transaction volume doubled in the last three years and management's expectation is that it can do it again by 2015. Nearly half of PayPal's transactions come from overseas and 10% come from mobile devices; two markets that are growing rapidly. eBay recently announced a $50 mm investment in India-based Snapdeal.com, which is an online marketplace similar to eBay's site in the U.S. This investment will give eBay access to Snapdeal's 20 million users and distribution network. The more people that utilize eBay's services the more valuable the company can become, which my colleague Pat Dorsey refers to as an economic advantage building "Network Effect." We are comfortable with our ownership and recently increased our position.

When uncertainties surface about long term growth and the direction of profitability, the SEM-DIS requires us to take a hard look. We first mentioned our concern about a certain portfolio holding in our April 2012 letter when we wrote that this company's newer products may not be able to maintain recent gross margin profitability levels. Our concerns led us to reduce our overweight position in July of 2012 and then we lowered to a below core weighting in January 2013 as additional evidence supported this assessment.

The reason I delay the identification of this company is to get you thinking about the fundamental way we judge the companies we own, regardless of their popularity or obscurity. Our initial investment four and half years ago in this company came after the success was already established in its primary product and operating margins were on the upswing. At that time our qualitative analysis concluded that this company had a road ahead of it that was clearly bright, with geographic market expansion as well as market share gains from a superior product and user experience. This played out and from our initial price we more than doubled the value of our investment.

Competition has caught up and dimmed the prospects a bit as is evidenced in part by gross margin pressure. Although this company is very capable, our **SEM-DIS** does not factor into our analysis a major new "wow" product or service that is not quantifiable at present. This particular company has a very strong customer base with over 300 mm users and it has strong revenue growth on the services side of the business. However, this high growth services area of the business, representing 10% of company revenues, is not large enough at present to offset the products side of the business that is facing the pressure on margins and bumpy demand trends.

We sold our smaller remaining position in **Apple** (AAPL) in June but we will keep a close eye on business developments for this company. We took extra space to share our thoughts on AAPL because it is a very popular holding and is talked about on CNBC and covered in the newspaper almost daily. For many of us, including myself, it is a product and service we use throughout the day and it remains a very strong company financially. Take the name away, replace AAPL with XYZ, and if you reread the above few paragraphs you can see why the **SEM-DIS** calls for us to disengage at this time.

In our twenty plus years of experience managing client assets, we have sold a company from the portfolio and bought it back later on when it became clear the prospects improved, even if it cost us more. If AAPL can stabilize or improve its gross margins and reestablish positive earnings growth, we could become owners once again. This company is inexpensive based on its current earnings level and a demonstration of stable to positive trends could cause the stock price to rise, perhaps significantly. **SEM-DIS**, which has produced long term market beating results, favors companies that have a clear near-term and long-term path of intrinsic value growth which is lacking at present in this company.

PetSmart (PETM) is a new addition to the portfolio. PETM is the nation's largest specialty retailer of pet foods and supplies with about 1280 locations. The company also provides a host of services including grooming, veterinary (at over 800 of its retail locations), PetsHotels (at 200 locations) and adoption. PETM dominates the specialty retail channel with a 40% share, twice the size of runner-up privately held Petco. We believe growth will continue as the store locations continue to be not just places to pick up supplies, but a destination for pet owners to meet. The company is experimenting with smaller store sizes which put them within closer reach of its customers. PETM is also benefitting from the "humanization" of pets and the shift of owners buying organic foods and healthier based supplies.

<u>Look Out Below</u>
Fed Chairman Bernanke's motion signals that we are likely at the end of three-decade long decline in interest rates. Consider that in 1981 the three-month Treasury bill was 17% and today it is basically 0%. A lot of longer-term bonds have been sold recently at very low fixed rates. Nike and technology companies Apple and Microsoft issued ten-year bonds in April and May at a 2.3% - 2.4% and thirty-year debt at 3.6% - 3.9% yield range.

The owners of these bonds face at a minimum the risk that the return they earn will not keep up with inflation. The worst could come if they need to sell those bonds before maturity arises. When interest rates rise, fixed rate bonds can lose significant principal value. A one-percentage point rise in yield for a 30-year bond today will reduce its price by more than 15%; a three-point increase in yield will hammer the price down about 40%. Apple sold the bonds in early May and by the first week of June bondholders were staring at a 10% price decline to $900 from $1,000 per bond; a loss of three years' worth of coupon income.

<u>Summer-Time</u>
The Fed has been very transparent that reduced monetary stimulus would occur when the economy is improving so this news is neither positive nor negative. As long as we have a growing economy, increasing corporate profits and a relatively strong U.S. dollar, gradually rising rates are acceptable, especially if the interest rate on the 10-year Treasury settles in at a level about two percentage points above inflation, which is currently tracking about 1.5%-2%. We believe that equity valuations are reasonable and in particular believe our individually selected portfolio holdings are attractive since our overall earnings growth rate potential is well above the average business. We still believe individual security selection is the key to long term outperformance.

Best wishes for a terrific summer and thanks for your continued confidence. As always, we will be 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

Time Period	**SEM % Return***	**S&P 500 % Return**	**SEM - Value of $1,000,000**	**S&P 500 - Value of $1,000,000**
First Six Months 2013	+13.0%	+13.8%	$ 1,130,300	$ 1,138,200
One-Year	+21.5%	+20.6%	$ 1,215,200	$ 1,206,000
Three-Year	+17.4%	+18.4%	$ 1,616,200	$ 1,662,000
Five-Years	+8.8%	+7.0%	$ 1,525,200	$ 1,403,300
Seven-Years	+6.9%	+5.7%	$ 1,590,800	$ 1,470,100
Inception (15 1/2 Years)	+7.5%	+5.2%	$ 3,068,200	$ 2,194,800

* 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.

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