Suncoast Equity Management, Inc.

July 2, 2014

Dear Client:

At the half-year mark, our SEM portfolio is +1.4% versus +7.1% for the S&P 500. Our portfolio is very attractive on a relative basis because we are essentially priced on par with the market, yet we own a portfolio that offers better safety and growth. During the first half of this year we added some attractive companies with solid growth prospects and had to disengage from two holdings due to softer growth and a change in the competitive landscape.

Relative Value

We believe our portfolio is showing strong relative value since we are priced in-line with the overall market. Over the years, we have observed that our portfolio typically sells at a 10% - 20% premium. If the S&P 500 is trading at a 15 times price to earnings ratio then our portfolio would usually be valued in a range between 16–18 times. So how do we support this observation? SEM has always owned a small collection of companies that in aggregate boast stronger economics than the cumulative profile of the 500 companies that make up the S&P 500 stock market index or the nearly 1000 companies that comprise a broader market representation, such as the Value Line Composite. If we profile SEM versus the general market we discover:

	Profitability	**Financial Strength /Safety**	**Growth**	**Valuation**	
	Return On Total Capital	Debt to Shareholders Equity	2014 Estimated Earnings Growth	Price to Earnings Ratio	Earnings Yield
SEM	19.3%	22.0%	13.1%**	16.2x	6.2%
Market Average*	11.9%	61.3%	6.9%	16.7x	6.0%

** - Value Line Composite for Return on Capital and Debt to Shareholders Equity; S&P 500 data for Earnings Growth and Valuation.*

*** - Lowered Gilead Sciences earnings growth to conservative forecast from analysts estimates of +95% for 2014 due to new product intro.*

Four important measures draw this conclusion, (1) Profitability, (2) Financial Strength and Safety, (3) Growth, and finally (4) Valuation. Return on capital (ROC) is one of the best relative measures of profitability. We believe that ROC is a main driver of long-term stock price appreciation. For ROC, the higher the better, and the 11.9% average for the Value Line Composite is in reasonable proximity to the long term returns of the market. As you can see, ROC is much higher on average for SEM than the market averages.

Next up is strength and safety. Our debt to shareholders equity ratio is much lower than the market average (22.0% vs. 61.3%), illustrating that our companies don't need leverage to strive for high returns on capital. Also, the low ratio for SEM represents relative safety during good and bad times, such as when we experience severe economic contractions or mild recessions from time to time.

The ratio of debt to shareholders equity does not reveal anything about the cash levels on corporate balance sheets nor about an interesting trend at hand. The business headlines report an abundance of cash available on company balance sheets. In part, this abundance is from companies borrowing to take advantage of low interest rates as well as the need for companies to have more funds on hand in the U.S. as cash is "trapped" overseas. Cash "trapped" overseas is being caused by the reluctance of corporations to repatriate profits back to the U.S. from foreign operations due to a special tax the U.S. levies, which should be abolished in our opinion. A lot of the borrowed cash is being used towards record stock buybacks.

The end results for many companies are balance sheets bloated with equally higher levels of debt and cash, which we don't prefer. Although some of our SEM companies have participated, the significant difference is that most of the excess cash our companies generate is from operations, thereby adding further safety and future business investment opportunity. Over half of our portfolio is part of what we call the "net cash club", very positive net cash (cash minus all financial debt) and includes **Accenture** ($4 billion), **Apple** ($133 billion), **Checkpoint Software** ($3.7 billion), **eBay** ($3.7 billion), **Franklin Resources** ($8.2 billion), **Google** ($53.1 billion), **MICROS** ($658 million), **Microsoft** ($65.7 billion), **Nike** ($4 billion), **Priceline** ($4.9 billion), **Qualcomm** ($16.6 billion), **Visa** ($1.8 billion), and finally **Berkshire Hathaway,** whose last report commented that they have a "war chest" of $48 billion. Of course cash size is relative, where a smaller company such as MICROS generates $1.4 billion in sales (and has $658 million in net cash) whereas Microsoft is approaching $80 billion in sales (and has $65.7 billion in net cash).

Earnings growth is a driver of intrinsic value growth. The SEM portfolio as a whole is projected to grow earnings 13% this year, nearly twice the 7% rate for the S&P 500. As we turn towards 2015 in a few months, we expect to see a similar positive gap in earnings growth between SEM and the S&P 500, further supporting our stronger attributes.

The final consideration is price relative to value. The table above shows that the market is offering SEM (a higher quality portfolio) at a slightly better value than the S&P 500, or 16.2 times and 16.7 times earnings, respectively. Again we turn back to our observation that the S&P 500 is an index that consists of a mix of below, above and average companies. Earnings yield is the inverse relationship of the price to earnings ratio and it tells us that we get 6 cents of earnings for every dollar we invest. This current earnings yield is reasonable on an absolute basis and very attractive against most fixed income offerings.

So why is our portfolio on par with the market and why have we lagged in performance for the first half? It may simply be the short-term randomness of stock price movements. So far this year, the stock prices for over one-third of the companies in our portfolio, including **Accenture, Discovery Communications**, **eBay**, **Franklin Resources**, **Grainger**, **Nike**, and **Visa** are either flat or down. Are we concerned? Not at all. Much like the rest of our portfolio, these companies are on track to grow their earnings at attractive levels. As Ben Graham once said "the stock market is a voting machine in the short run and a weighing machine in the long run." Perhaps our companies are just not popular with investors near term, but we have every belief they will "weigh in" with greater value over time.

<u>Relative Strength (Portfolio changes)</u>

Within the landscape of companies that meet our criteria, we are looking for relative strength. Last year we added one company and sold two. So far this year we have been a bit more active by adding four companies and selling four.

Earlier this year, and just this past month we sold two retail businesses, **Bed Bath and Beyond** (BBBY) and **PetSmart** (PETM) from our portfolio. Both of these holdings were small positions for a short period of time, BBBY for about fifteen months and PETM for about a year. In the end, we lost a little more on a percentage basis on PETM (-15%) than we made on BBBY (+13%), and the net impact to the portfolio was immaterial. The retailers we have owned recently and in the past have always been well established niche players with great balance sheets. PETM and BBBY were no exceptions. Our original thesis for both included (1) good value, both were trading at values below market averages yet exhibited high return on capital profiles and earnings growth (2) both had a business niche and some business levers that were still in progress and driving earnings growth, and (3) both were balancing capital allocation between investment in the business and generous return of capital to shareholders. However, we removed both from the portfolio as it recently came to light that they may be at the front edge of an increasingly more competitive landscape. Shifting consumer buying patterns fulfilled by up and coming online entrants such as Wayfair, in the case of BBBY, and PetFlow in the case of PETM may be causing some pain. Amazon is not the only trusted brand being built online, though it is also having a competitive impact. With more places to buy similar product offerings, pricing is getting more competitive. A sidebar to all of this is the benefit consumers reap by increased choices at lower prices, keeping inflation low. In retail, management execution is also very important, and while both seem to have very capable stewardship, we let the business results tell the story. Neither of the two companies will deteriorate like Circuit City, a retailer loaded with debt when the throw-down in the highly competitive electronics segment took center stage a few years ago. Yet for the **SEM Disciplined Investment System (SEM-DIS)**, once a company stalls or reverses from our original thesis we shop for better opportunities.

Priceline (PCLN) joined our line-up of great businesses this quarter. Many of you may be familiar with its namesake discount travel website "Priceline" and lead pitchman William Shatner. Its best asset though is an overseas hotel services website called Booking.com. In sharp contrast to most travel sites in the U.S., Booking.com is much more profitable because it operates on an agency business model, receiving a commission or fee for the reservation. The typical travel website takes on the responsibility of ownership of the hotel room and has a high cost of revenue. The Booking.com model does not have cost of revenue expenses. This very profitable part of PCLN's business represents 60% of revenues and should continue to grow in excess of 15% annually over the next five or more years. Overall, the company is heading towards becoming the world's largest online travel agent and its global market share of travel bookings is less than 4%, versus 1% five years ago. We hope to be part-owners of PCLN for a long-time as they continue to exploit a strong position in underpenetrated international markets.

We sold **AbbVie** (ABBV) because we own the current leader in Hepatitis C treatment, **Gilead Sciences** (GILD). ABBV was a smaller position for us as a result of its spin-off from **Abbott Labs**. ABBV has been trading higher on the prospects of its alternative therapy to GILD's Hepatitis C treatment, so we believe we received a good price. Our above core portfolio commitment to GILD reflects our current belief in its product advantage. Among other factors, GILD has first mover advantage with its product already in use while ABBV's product will not be on the market until closer to year end. We had no plans to increase our ABBV position to a larger core weighting so it was sold to support the purchase of new opportunities. Most of the time our smaller weightings in the 2%-3% range reflect either new holdings making their way towards core holdings, or it can be a company with a solid business outlook and a stock price near fair value.

Honeywell (HON) became a part of the portfolio as we utilized proceeds from the sale of ABBV for the purchase. The manufacturing technology company's core operations consist of four groups (1) controls, sensors and security products for commercial/residential as well as factory, including heating/cooling and building automation (roughly 40% of revenue), (2) aerospace products and services specializing in engines for business and regional jets and flight navigation systems (30%), (3) process technology for refining, and petrochemicals which help heavy energy users become more energy efficient (20%), and (4) turbochargers for automobiles (10%). HON's productivity improvements during the past few years and its future plans are impressive. We expect the company to continue to drive operating margins upward, perhaps another two to three percentage points over the next five years, which is a preferred data point for the **SEM-DIS**. Meanwhile, the company has a meaningful backlog of business and should grow overall revenues in the 4%-5% range.

We also sold **Express Scripts** (ESRX) during the quarter. Our original purchase was shortly after it acquired Medco Health (MHS) a few years ago on the premise of increasing volumes and economies of scale as the largest pharmacy benefit manager (PBM). Management announced in April that those trends have reversed as volume is expected to decline this year due to the loss of United Healthcare's business, lower enrollment in public exchanges, and clients being acquired by "non-clients." Although ESRX remains the dominant PBM, we question whether the company is over playing its advantage by charging clients too much and not passing along cost savings it was designed to create. The opaque nature of sales price to cost relationship may be creating an opportunity for emerging competitors to gain a toe-hold. Management believes otherwise and also believes that volumes will turn back to positive soon. For **SEM-DIS**, with no revenue growth expected for the remainder of this year, lower retention, and lower operating profit, we shifted our investments to better growth prospects.

As you may know, we are big fans of the entertainment content business via our ownership in **Discovery Communications** (DISCK). One of the key investment factors is that channels for content distribution continue to expand via the (1) internet, (2) devices such as mobile phones and tablets, (3) venues such as in cars and in airplanes, and (4) geographic expansion beyond our borders due to the popularity of U.S. created content. We now own the two best content companies, as we recently added **Disney** (DIS) to the portfolio. Our content ownership has expanded beyond lower cost yet popular reality programming seen in the Animal Planet and Discovery Channel (such as "Shark Week" and "Deadliest Catch") to the best sports content and likely the largest animation and character content company. DIS's operating results today are driven by the great success of its ESPN Sports franchise, which accounts for nearly half of its operating income. We believe additional growth is coming from its success in accumulating great character franchises over the last seven years such as Pixar (Toy Story and Cars) for $7.4 billion, Marvel Films (Captain America) and Lucas Films (Star Wars) for $4 billion each. Bob Iger of DIS is a world class CEO. He has had a clear strategy since he became CEO in 2005 that the company would benefit from more enduring characters like Mickey Mouse. Both he and David Zaslav, CEO of DISCK, are what we refer to as great "wealth-building" managers.

We added a small position of **Apple** (AAPL) back to the portfolio. You may recall that our decision to sell AAPL in 2012 and through mid-year last year was due to a peak and then subsequent decline in operating margins. We believe that AAPL's recent business results show that its ecosystem among its current users and the attraction of new users in mature markets such as the U.S. are leading to sustainable operating margins. If this business development continues to gain strength then we will increase our weighting. Since we have had a few folks ask what the next "big thing" is for AAPL, and because we answered "we don't know," we would like to share one key point in regards to our investment and our SEM-DIS. SEM-DIS never invests on the hope or speculation of unannounced products or services. We base our decision on the current line-up and expectation of its existing products such as the smartphone and believe that the continued success of this product, including future improvements, can generate modest and reasonably good single-digit revenue growth with earnings advances a bit higher. If customers keep up the demand and AAPL can execute, we can earn very satisfying returns.

Our lag in performance so far in 2014 is a natural by-product of a concentrated portfolio. Our businesses are doing well and our concentrated portfolio will always experience short periods of time that may not be in sync with market trends, up or down. According to institutional rankings from Informa PSN at year end 2013, SEM's three-year and since inception (16 years) rank among our peers in Large Capitalization Growth was top 1% and top 6%, respectively. We only display the scoreboard every so often so our investors keep a focus on longer term results versus short term, such as six months to one year. Importantly, our internal focus is on the players on the field (companies that we own) and from that perspective we continue to believe in their achievements ahead. 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 Jowdy

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 2014	+1.4%	+7.1%	$ 1,014,400	$ 1,071,400
One-Year	+22.2%	+24.6%	$ 1,222,100	$ 1,246,100
Three-Year	+17.7%	+16.6%	$ 1,629,700	$ 1,584,600
Five-Years	+17.2%	+18.8%	$ 2,212,300	$ 2,369,800
Seven-Years	+7.8%	+6.2%	$ 1,686,500	$ 1,519,200
Inception (16 1/2 Years)	+8.3%	+6.3%	$ 3,749,700	$ 2,734,900

* 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.