Suncoast Equity Management, LLC

April 4, 2017

Dear Client:

Following the post election rally of last year in which certain market sectors like energy, cyclicals and financials led the market, the first quarter scorecard of 2017 may be signaling a return of focus towards companies with sustained earnings growth ability. The SEM client account composite closed the quarter + 8.9% versus +6.1% for the S&P 500. Long term investment success requires both a process and a discipline, without it is like sailing the seas without a compass or today's equivalent GPS. As time evolves that process and discipline must grow with it. The guiding principles, within our **SEM-DIS** (Disciplined Investment System) that keeps us sharp, involve identifying businesses with the best fundamentals, momentum and attractive valuation. We talk more about this below and discuss our portfolio changes in the quarter.

<u>Portfolio Update</u>

We welcomed two companies to the portfolio and sold two. We had a terrific long term experience with **Gilead Sciences (GILD)** but not a very good 2016 and early 2017. We purchased GILD in 2009 for an average price of $21.80 and sold for an average price of $67.60. At purchase, revenues and operating margins were expanding due to its leadership in HIV treatments, with the number of patients being treated increasing as well as prices. In 2012, GILD purchased Pharmasset which led to its blockbuster cure for Hepatitis C with just one pill a day. GILD has cured more than 1 million of the estimated 185 million people that have Hep C, which led to its sales tripling and earnings rising six-fold from 2013 to 2015. In 2016 Hep C sales fell from their peak due to faster cure rates, more competition, and pricing pressures. Meanwhile, GILD's HIV franchise won more approvals and continued to grow offsetting most of the decline in Hep C. We trimmed our position last fall but held on to the stock believing we at least had a business with flat intrinsic growth. We accepted flat growth anticipating GILD would make an acquisition like it did in 2012, as it was accumulating cash from both HIV and Hep C. In fact we applauded its patience in 2016 as we witnessed one or two deals cross the tape at high valuations that GILD passed on. Unexpectedly in February, the company forecasted that Hep C sales would be down significantly in 2017. With the company facing a near term decline in intrinsic value, we sold our remaining shares.

We used the proceeds from the GILD sale to initiate a position in **Stryker (SYK).** SYK is a medical technology company that specializes in Orthopedic Implants, MedSurg Equipment, and Neurotechnology & Spine products. The company posted broad-based underlying growth in all its markets the last few quarters and expects low double digit earnings growth in 2017, due to acquisitions, market share gains in Europe and emerging markets returning to growth. Stryker intends to roll out its Mako robotic knee in early 2017, which management believes could be a disruptive technology for patient outcomes as well as physicians.

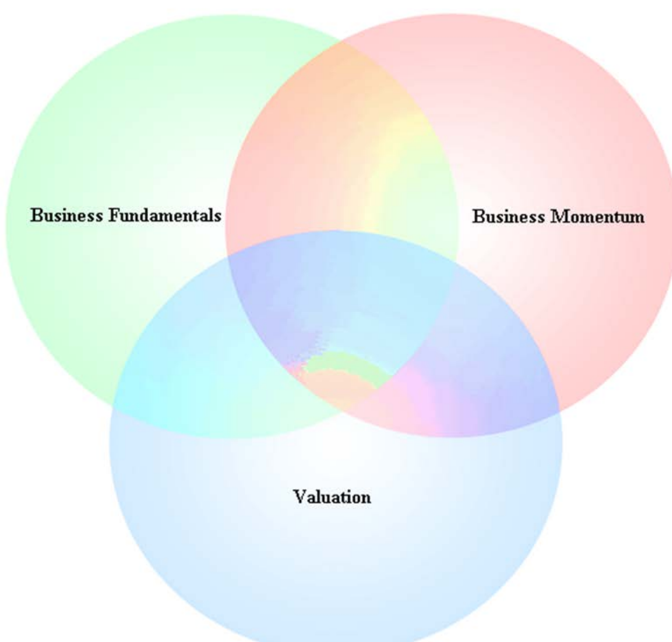
We also recently purchased **VMware (VMW)**. VMW provides virtualization software solutions which allow its customers to optimize complex computer systems and generates about 60% of its revenues from services and 40% from licensing. One of its fastest growing segments is its hybrid cloud and SaaS (Software-as-a-Service), which posted double-digit growth across all regions. VMW has business momentum with high renewal rates and solid new customer additions. With 20% returns on capital, as well as consistently increasing revenues and operating margins, we look forward to increasing our position over time.

Much like the change in how people consume their entertainment content (via mobile devices and from various sources other than cable TV), the channels in which they buy their goods is in an accelerating state of change, like household items, clothes and footwear. While Amazon has been a driving force, consumers are also going direct to the online site of the product provider, known as DTC (direct to consumer). We believe that **Nike**, a long term holding for us, is well positioned to navigate the shift in the retail environment. However, this state of disruption is interrupting **Hanesbrands (HBI)** business strategy of buying global brands and increasing scale. As such we decided to sell our holding.

HBI will likely make it through the transition but it could be a rough ride. A bit more discussion to take you through our thought process from genesis to sale may be helpful. When we first invested in HBI a few years ago, its economic moat and advantages of scale were gaining strength. The company is a global leader selling 2 billion units a year in the Innerwear and Activewear markets through brands like Hanes, Maidenform and Champion. Unlike competitors, it owns its supply chain which allows HBI to manufacture its products for 15-20% less than its peers. Innovative new products like X-Temp, ComfortBlend and Fresh IQ have increased margins, as well as acquiring international brands to boost its economies of scale. HBI's execution on its strategy has been solid. While we watched the shift in retail decimate some particular channels early on such as electronic retailers, it has only been the last year or so that the shift as to how and where consumers purchase apparel and footwear has accelerated. HBI's retail lines are more basic (socks, underwear, t-shirts) and less fashion-oriented so the business by definition should provide a bit more margin of safety. We believed they could continue to execute their business plan during the shift and in fact the company reported solid third quarter results last October. But with retailers such as Macy's struggling this past holiday season, Walmart recently announcing that they need to take inventories as low as possible and Dick's Sporting Goods eliminating 20% of its vendors, that caused us to conclude that even the basics market may be becoming less predictable. One point of debate is the impulse purchase of innerwear. If you visit a store for one item but then see that innerwear is on the next shelf, it can result in a purchase. But when you buy online, you only buy what you need. HBI has taken on more working capital such as inventory and account receivables, as well as some debt, by acquiring Knights Apparel, Champion Europe, and Pacific Brands. We were comfortable with the short term increase as part of their scale strategy, until the acceleration of change in retail quickened. With the online shift creating less predictability we also decided to pivot. We don't like the loss we incurred during our two plus years of ownership, but we made a judgement to sell based on our view of the direction of the fundamentals. As we used the proceeds to purchase VMware, we will now further discuss below how relative stock selection occurs within our discipline.

Fundamentals, Momentum and Valuation

SEM-DIS is built to weather the economic climates. Investing through all economic cycles is achieved by SEM-DIS focusing its efforts on companies with strong and sustainable fundamentals, momentum and an attractive valuation. When these three circles intersect, we get excited.



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Fundamentals ask if the company's products or services are in need. For example **Middleby**, one of our portfolio holdings, sees steady demand for its energy and labor saving equipment from restaurant chains. As **Nike** brings innovation and performance to its athletic shoes, customers demand and pay more. Contrast that with General Mills cereal or Campbell Soup's primary product where consumption has been tepid at best for many years as consumers shift preferences for food items. A company's rank within the industry is an important fundamental indicator. Most of the companies in our portfolio either lead or are in the top two. On the financial side, fundamental analysis addresses the strength of the balance sheet, income and cash flow statement. We prefer companies with low debt and we are ok if they are holding a sizable cash balance. Importantly we favor businesses that consistently generate cash in excess of capital needs and expenditures. The business needs to earn an above average return on equity and capital, preferably 15% or higher, compared to the average which is approximately 11% for publicly traded companies. We also examine profitability levels against other industry participants and the broad landscape of 3,500 or so companies in our universe.

Business momentum is a very important factor in our **SEM-DIS**. It can be identified not just by the obvious measures of organic sales but importantly by changes in gross and operating margins and the components within. McKesson, during our successful seven plus years of ownership, drove its operating margin up by 50% to 2.3% from 1.5%. We believe our recent purchase of Facebook shows the similar potential to meaningfully increase operating margins, though perhaps not quite on the same scale. We also look at the change in the levels of investment such as research and development and capital expenditures and how that corresponds to growth in sales. New products and services that increase customer demand is an important component of business momentum. **Accenture**, a company we first purchased for clients nearly eight years ago, is one of the global leaders in management consulting, technology and outsourcing services. Its new services segments of digital, cloud and security have grown to make up 45% of total revenues. Smart acquisitions can add momentum. **Visa's** recent purchase of Visa Europe could lead to both margin improvement of the acquired business and innovation of new products serving a large number of users of their products on both continents. **Disney** is another example of how smart acquisitions can lead to business momentum. We have talked about it in the past, and we are a big fan of CEO Robert Iger and his capital allocation track record, especially in the film segment with the likes of Lucasfilm (Star Wars), Marvel and Pixar. With those assets, DIS released five of the ten highest-grossing movies in the U.S. in 2016. We are also delighted that Iger extended his contract with DIS and will remain on board until July 2, 2019.

Valuation is always *relative*, and importantly we measure it on an *absolute* basis as well. We view each security bottom-up and view it across asset classes. From a top-down perspective, we compare fixed income yields against equity yields (multiples). The current landscape for the equity market in general and high quality fixed income as a comparison is in following table:

	S&P 500	Treasuries	Muni Bonds (1)	Corporate Bonds
Yield	5.5%	2.4%	3.6%	3.0%
Price to Earnings Ratio	18.1	41.8	29.3	33.8

(1) Tax-equivalent yield with an assumed 35% tax bracket

Composite Fixed income yields for ten year time frame; muni and corporate AA or better

The yield above for the S&P 500 is the earnings yield (the inverse of the price to earnings ratio). We can compare this to the fixed "earnings" yields of treasuries, municipal bonds and corporates. For some time now, earnings yields have been low on fixed income instruments. Equity earnings are not guaranteed (or as certain as high grade bonds) so that earning the yield in the table above will depend on how accurate earnings estimates are for the market index and how our economy will grow this year. Nonetheless it is a baseline for how we compare each security we evaluate.

As we drill down to choosing between individual securities, one of several important steps we take in valuing equities is recognizing that *return on capital* is an important indicator that separates the herd. We mentioned earlier in this letter the average return on capital for the average publicly traded company is approximately 11%. To keep it simple, if you have a company that earns a higher return on capital than the average company then it could be more valuable to own and may sell at a higher multiple. We avoid companies that consistently generate returns on capital below the average business.

A good example within our portfolio on a *relative* valuation basis is our sale of **Hanesbrands** and our purchase of **VMware**. In our daily work we use free cash flow yields, which we believe is a better measure than earnings yield. So at the time of our purchase of VMware and sale of HBI, both were valued at 6.5% free cash flow yield, a more attractive valuation than the average company in the S&P 500. Both earn returns on capital close to 20% but VMware has a stronger balance sheet with net cash (cash less debt) of nearly $6.5 billion. Add to that the positive business <u>fundamentals</u> and <u>momentum</u> we talked about above and compare that to HBI. HBI is currently facing challenges from a shift in the retail landscape (lack of momentum leading to weaker fundamentals) while VMW has the wind at its back in the cloud computing space (business momentum). So essentially it was an easier decision to make because *VMware is at the intersection of all the important components of business fundamentals, momentum and valuation.*

<u>Spring ahoy!</u>

Stock prices can diverge from fundamentals, especially in the near term, as last year's events like Brexit and the Trump election exhibited in a very unusual 2016. Meanwhile this year like last year, is shaping up to be another good year of earnings growth for the SEM portfolio. Over time the market will reward companies that deliver strong and sustained earnings growth, which is exactly what the **SEM-DIS** (Disciplined Investment Process) seeks. We thank you and are grateful for your confidence.

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**
First Quarter 2017	+8.9%	+6.1%	$ 1,089,100	$ 1,060,700
One-Year	+6.1%	+17.2%	$1,060,700	$1,171,700
Three-Year	+6.7%	+10.4%	$ 1,216,000	$ 1,344,500
Five-Years	+10.9%	+13.3%	$ 1,675,400	$ 1,867,100
Ten-Years	+7.8%	+7.5%	$ 2,123,900	$ 2,062,700
Inception (19 1/4 Years)	***+8.1%***	***+6.7%***	***$4,466,200***	***$ 3,494,100***

* 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