SUNCOAST EQUITY MANAGEMENT, LLC

January 2, 2018

Dear Client:

SEM is celebrating the completion of 20 years! In 2017 our client account composite rose 30.9% versus the S&P 500 market index of 21.8%. This is a long letter from our standard two-three pager, but we have a lot to share with you. Read in a few different sittings if you have to as we hope you agree after you finish it was time well spent. We cover in some detail the fascinating role economic moats have played in the rise of some of the global super companies. We also discuss how moats evolve and drive profit margins and our usual dedication to portfolio activity along with an update on Disney. We finish with some thoughts heading into 2018 and some 20 year anniversary observations and thanks.

We want to thank all our clients both at the beginning and end of this letter. We equally thank those that have been with us for over 15 years and those that are just beginning the journey with us. While we have great confidence in our investment process, we continue to work hard at improving it and keeping a humble attitude. Our mindset is that we never stop learning. We don't often toot our own horn but feel from time to time it is important to tell you where we stand in terms of whom you partnered with and share with you what we hope to repeat in the next 20+ years. Informa/PSN, an institutional data collector on money managers, ranks SEM in the top 10% since our inception in the categories of both large capitalization and large core investment management. Equally notable is that Morningstar, a more popular database of both mutual funds and separately managed accounts, ranks us overall as four out of five stars, and the ranking only covers the most recent ten years. These are good measuring tools for us and for you to know where we stand, even though we have every intention to try to improve on these rankings over the next 20+ years. Below is the table showing growth of $1 million invested since inception and the annualized net of fees return versus the market (S&P 500).

	SEM	**S&P 500**
Growth of $1 million	$5,366,900	$4,013,500
Annualized Return	8.8%	7.2%

Economic Moats (and the rise of Global Super Companies)

So let's get down to the basics for a quick moment. Why do businesses exist and what do they seek? Businesses exist to serve consumers and ideally to earn a profit for their efforts. So what is the consumer looking for? Consumers seek products and services which satisfy their needs, represent good value for the money they lay out, and are always in the pursuit of saving time. Importantly, we all embrace and seek improvements in the quality of the services and products that we consume as it leads to improving our living standards.

Over time as consumers seek greater quality and value, businesses evolve, grow or die trying to meet those needs. As investors, we believe we have a well thought out process and discipline for identifying better businesses. We refer to our process as the **SEM-Disciplined Investment System** (SEM-DIS). Since inception we have achieved outperformance of the overall equity market while taking less risk. The SEM-DIS accomplishes this by seeking out growth businesses with strong balance sheets and those which consistently generate excess free cash while earning above average returns on capital. The process we created 20 years ago will always maintain the solid attributes we just mentioned but will keep tweaking as businesses evolve.

Network Effect and Global Super Growth…

Over our history we have owned a range of businesses from small to mid to large capitalization. Internally, we have observed and discussed how interesting it has been to witness the rapid growth of some of the very largest companies on the face of this earth. These companies, which have grown from nothing to hundreds of billions in revenues in a short period of time, include some within our portfolio that have met our criteria (Alphabet, Google, MasterCard, Visa), some outside (Amazon, Alibaba, Netflix and Tencent) and some that may be up and coming (Tesla). We understand the economic reason why they have grown so quickly; it is referred to as the *network effect*, in which the value of businesses' products and services increases with the number of users, especially from a global perspective. Companies with strong *network effect* characteristics exploit their innovations and the internet's connectivity to accelerate their success. This should help you understand why your portfolio holds what appear to be more technology companies. Simply put, technology companies today are the industrial companies of thirty years ago. Industrialization, again as Morningstar has observed, has moved from mechanical and mass production to information technology. Some of our important holdings are advancing towards the next "industrial age" as artificial intelligence includes the sub categories of deep learning, natural language processing and computer vision, all of which we recommend you google as it is fascinating stuff! We talk more about the importance of network effect in our investment process below in our Portfolio Activity section as we discuss our recent ownership in **Adobe (ADBE)**.

Morningstar recently observed that some moats are more beneficial than others and identified that the *network effect* is one of the most powerful and enduring in today's economy. They also believe that the *network effect* tends to drive the highest level of profits. Morningstar further concluded that today's largest companies, when compared against those of 30 years ago, possess more and wider moats especially the *network effect*. For example, our core holding **Facebook (FB)** possess up to four economic moats including *network effect*, *brand name*, *switching costs* and *scale*. Just ask Myspace, the last company we can recall as a direct competitor, how powerful FB has become. At one moment in time Myspace was the most visited site on the web and is now no longer while FB has 2 billion users.

What is striking to us is that Morningstar believes these large companies with *network effect* moats could see their advantages last for decades. We have always characterized that each and every business is a living breathing organism that changes with time. In connection to this we say that we observe the current condition rather than predict the future direction of a business' economic moat. We do our best to judge if it is experiencing a tailwind, neutral or headwind (erosion). We hope Morningstar is right, that these companies' moats may last for decades. But we are content to observe and believe with some of these very large companies that they will increasingly collide in each other's space to deliver an array of innovative products and services supported by overlapping revenue streams, such as advertising. With FB as our example, their new product Facebook Watch, which is off to a bumpy and slow start, is aimed at drawing its powerful 2 billion members to spend more time watching longer length videos on its site. FB is attempting to draw viewers and advertising revenue away from conventional television/cable, internet streaming businesses such as Alphabet's very successful YouTube, and Hulu (independent but soon to be majority owned by Disney).

Moats can drive profit margins above the norm…

A remarkable outcome and observation from Morningstar's research is that the power of the *network effect* in combination with other types of moats has driven profit margins to above historical norms. In fact Morningstar's observation is that profit margins have expanded rapidly over the past three decades. As you may know from our previous letters, increasing margins is a key business attribute we seek in executing the **SEM – Disciplined Investment System** (SEM-DIS). SEM's clients own a few of these businesses including aforementioned FB, GOOG, V and MA but missed out on some other successful companies because the severe volatility of their profit margins has kept us away, such as Amazon and Netflix.

Morningstar believes higher margins relative to history for these businesses may be sustainable even when the business cycle softens because of the durability and defensibility of the competitive positions these businesses possess. Of course, over time high margins always attract more competitors. Also with the quick rise of these very large companies, we are not exactly certain what kind of additional expenses come along with that. Again drawing on our ownership of Facebook, the company announced that they expect costs to rise 60% next year dampening margins, because of the increased responsibility to properly police the content that makes its way onto its platform. For fast growing companies we don't own, the reason can be that the company is still in an intense spending mode to support its expansion such as a Netflix (NFLX). While these very high profit margins may come down a bit because of increased costs, they can be offset by continued strong organic growth and potentially by pricing power, as here again the *network effect* or *switching costs* allow FB to charge more for access to its user base. Time will tell and we will be very watchful.

Moats will shift and are born and die with the sands of time…

As mentioned above, economic moats come in different forms and in addition to *network effect* include *intangible assets* (including brand equity and patents), *advantages of scale* (and low cost advantage), *switching costs* and *cost advantage*. Moats also will evolve and shift as some will weaken and die while others will be born and gain strength, and the future may bring new ones that are yet unidentified. Investors have sought economic moats throughout the history of time. Some of the best at seeking businesses with moats in recent times of course include Warren Buffett and his partner, Charlie Munger, both of whom have been doing this for more than 50 years. However over time, innovation and technology can erode the sands beneath even the best investors' one-time moaty businesses.

One of the best examples of a moat that changed driven by consumers demand for greater utility from a product and value for money spent is in the area of information and education. GOOG's original mission statement was to "organize the world's information and make it universally accessible and useful." So where have we heard something similar before? Travel a bit further back, how about the World Book Encyclopedia whose mission was and still is to "cultivate lifelong learners—because today's explorers are tomorrow's leaders."

In 1985 **Berkshire Hathaway (BRKb)**, bought World Book Encyclopedia as part of a larger acquisition of the Scott & Fetzer Company. World Book is celebrating its 100^{th} anniversary this year and I bet you did not know that you can still purchase a set for $999. When Buffett first purchased the company it had sales of approximately $275 million and when he broke out the operating results in 1990 revealed it had pre-tax earnings of $31 million. A recent *Businessweek* article also reported that at one point likely back in the 1950s, the business employed 40,000 door to door sales folks. Of course with innovation and the web's interconnectivity, we fast forward through the 1980s era of Microsoft's Encarta CD-ROMs to the rise of the free online encyclopedia, Wikipedia. So here we are today utilizing our Google browser to access all the same information plus more for free that families at one time had to pay a hefty price for and likely finance with installment payments. Even more revealing as it relates to the rise of large and very profitable companies, GOOG today shockingly employs only about twice the amount of people globally (75,000) than World Book once did, yet it generates in excess of $100 billion of sales and $25 billion in net income. Now that's progress!

Intangible to Tangible Brand Shift (User Confirmation)…

Moats can shift with time as well. Let's explore whether *intangible brand* strength may be permanently shifting to *tangible brand strength.* At this point we are all familiar with the brand and service strength of a company like Amazon. It brings us so much value in its ease of use that many of us don't even price shop. If Amazon has the product we assume the price is low enough in exchange for the convenience of getting it quickly to our doorstep (2 day service no charge for prime members) versus getting in the car to head to the store. But something larger is at work!

While brands are still very important when it comes to trust, we now see an emerging moat that might one day be its own category called *tangible brand moat*, with the subset *crowd or user confirmation.* Let's travel back in time again and we don't have to go too far back, say a decade ago. The most trusted name in men's personal care for shaving was in the hands of two primary providers that had dominated for a very long stretch, Gillette (owned by Procter & Gamble) and Schick (now owned by Edgewell). In the last five years we have seen an emergence of upstart brands like Dollar Shave Club. Shaving is an important task, running a sharp blade against your face requires more attention and thought than purchasing copy paper for the office. With the benefit of positive consumer reviews and the power of the internet for users to promote good products, Dollar Shave Club is taking market share from its much larger rival and forcing Gillette to cut prices to stay competitive. For years Gillette was able to increase prices on its "improved" products by adding additional blades. Those efforts seemed to have peaked. Consumers benefit by not only getting a less expensive, high quality product but also by the convenience of automatic reordering.

Crowd or user confirmation is such an important component of a company's *tangible brand* strength that it is touching every type of product and service. Today user ratings on everything from hotel stays to automobiles down to a simple t-shirt or kitchen utensil are easily accessible. Just type the words of any product or service into a search browser with the word "review" next to it. Of course we still want to get our items from a trusted source, but this shift is giving distributors an opportunity to steal business directly from manufacturers. This is similar to the early days of private label brands first emerging in grocery stores. If you shop for a cashmere sweater online at either Target or Amazon and the one at Target is appealing to you and it gets nothing but great reviews versus the one from Amazon, you will not care if the label says Ralph Lauren or Michael Kors. In fact, you might be delighted that you did not have to drive in the rain or snow over to Neiman Marcus to look for one. We pay attention to this as it impacts all of our businesses and in particular companies such as **Nike (NKE)**. NKE understands the shift in distribution and it also understands it will need to continue to innovate to create highly desired value added products that will get high *user confirmation*.

Portfolio activity

This quarter we sold our interest in **Middleby (MIDD**) to make room for increases in two of our newer holdings **VMware (VMW)** and **Adobe (ADBE).** We first discussed VMW in our April letter and results continue to excel as the company builds its capabilities in the network and storage virtualization platforms while scaling back its reliance on the more mature on-premise server data center environment. VMW's products/services allow customers to consolidate multiple servers, storage infrastructure and networks together into pools of capacity that can be allocated securely to other applications on demand. This software platform reduces the need for hardware and therefore capital spending, as well as automates complex systems for corporations making them more efficient. With broad-based growth in all its products and geographies, VMW increased its revenue targets to +11% and EPS to +17% in its most recent quarterly report.

Our newest addition ADBE was initially purchased in late September**.** ADBE is an industry leader in Digital Media and Digital Marketing and benefits from the network effect, as well as high switching costs. In other words the value of its products and services increases with the number of users and once clients start using ADBE, they are very loyal. Most are familiar with Adobe's legacy products like PDF, Photoshop and Illustrator. But new products like Adobe *Experience Manager* allow automaker **Audi** to create a digital showroom. Adobe *Analytics* helps **Fox Sports** update its digital advertising strategy in real time and **Microsoft** has integrated Adobe *Sign* into Office 365, which allows its 100 million users to sign documents electronically. As a result of these new products and services, the company has been very successful at transitioning clients from a one time licensing fee to recurring digital subscriptions, which have grown from 15% five years ago to 85% of revenues today. After a very strong December earnings report we increased our position. Oftentimes investing is a relative decision for us as it was this quarter with Middleby. This begins with our belief that the optimal setting for long term outperformance while taking less risk versus the overall market is grounded in owning approximately 20 companies versus owning a large collection of stocks that directly mirrors the market. In comparison, most mutual funds and investment strategies hold close to 100 or more positions.

Quick side note: when the number and the holdings in aggregate differs substantially from the stock market indexes, the investment industry refers to that manager as having high active share. SEM has high active share and that is an attractive attribute that institutional investors look for, especially when combined with our patient investment approach. However, with a patient investment approach, our performance scorecard in the short run can differ significantly from the market index in any one year period, as we experienced in both 2016 and 2017.

Back to the discussion at hand - so we are often faced with the decision when we want to increase an existing holding or add a new holding to review our portfolio for what may be our nineteenth or twentieth favorable holding. We needed to find some cash to support our increases in VMW and ADBE and it came from the sale of MIDD. MIDD is a solid company and we only had a few concerns to warrant the sale. We purchased MIDD on the premise that it is a problem-solver for its clients, which we like. It makes restaurant and commercial food equipment that improves productivity and reduces waste. The company is also what we characterize as a wealth builder, applying free cash flow accumulation towards the purchase of smaller but relevant acquisitions to support growth. MIDD has been working its way through some order delays during the last few quarters. While we don't believe it is a greater competitive scenario, we respect that the recent spin-off of Manitowoc's Foodservice business in the same industry, Welbilt (WBT), may be bringing more of that focus into play. Shortly after we purchased MIDD in late 2014, their Residential Kitchen segment issued a major recall of their Viking brand and they have been working since then to reset the product line. As they work on this we also believe the high end of the residential market may be leaning toward technology based products such as Samsung and Bosch. Another factor that we recently weighed was MIDD's surprise capital allocation announcement to buy back stock. The stock's valuation at this time is ok but not super cheap and for MIDD in particular we favored capital allocation toward acquisitions that further the goals of their clients, like increased productivity and reduced food waste. The message to us is either they are trying to soften the blow from delayed orders (which will always be lumpy for capital equipment) or the opportunity for acquisitions is temporarily or even permanently reduced. MIDD is a good business and will make its way through these observations, but for SEM it is always relative.

Mickey and Goofy say stay a little longer (for intrinsic growth sake!)

As the landscape for consumption of entertainment content has been shifting to internet streaming and away from cable TV, we have admittedly watched with some nervousness as it relates to our ownership in the **Disney Co. (DIS)**. DIS announced on December 14th the largest deal in its history, with the agreement to merge into the company various assets of 21st Century Fox for a combined value of $66.1 billion in stock and debt. We plan on maintaining our ownership at this point in DIS for the reasons we discuss below.

DIS's announcement is a balanced move from our standpoint with both offensive and defensive elements and is focused on what drives the most value in media which is content, not the distribution pipeline. We have stayed away from much of the pipeline and other communication distribution companies, such as **AT&T** and **Verizon,** since they never met our standards due to their low quality balance sheets and muted growth prospects. We have felt content providers add more of the value to the consumer proposition, though these businesses including DIS are facing growth challenges and moat erosion. We previously owned Discovery Communications (DISCA) for about four years and made money for our clients, but sold it in August 2015 because of these concerns.

A bit of history is helpful here; in fact, the transaction reminds us of the earliest major media merger deal that signaled a new era. In 1985 Capital Cities Communication (CCC) bought ABC for $3.5 billion and it worked out fairly well for investors who stayed. The skinny on that deal back then was each stock had roughly the same market value but slightly different profiles. CCC, the acquirer, had revenue of nearly $1 billion and earnings of $135 million and it bought ABC which had $3.7 billion in revenue and $195 million in earnings. The difference was CCC owned television stations, newspapers and other publishing operations. What it needed to own was more content producers like ABC and ESPN networks as the economics of the TV stations were becoming less attractive, especially with cable, the new distribution platform, at the forefront.

It was later on in 1995 when Michael Eisner thought it was a good idea for Disney to purchase Capital Cities/ABC for $19 billion and merge DIS Hollywood film studios, Disney Channel, theme parks and consumer products supported by its cartoon characters with the ABC and ESPN networks. Here again the emphasis was moving towards content and new distribution channels as cable TV was flourishing.

DIS's new deal, assuming regulatory approval, is to merge in 20th Century Fox's content studio, cable networks including FX, National Geographic, Star India, a 39% stake in Sky, and 22 regional sports networks. DIS will also gain majority control of streaming video service Hulu. For DIS there is both opportunity and a lot to do. The acquisition of these assets makes DIS not just a company with a global brand but also makes them a global company. Sky is a British pay-tv operator that holds a lot of foreign rights to DIS films including the franchise "Frozen." Owning Star India will pave the wave for growth in one of the most attractive markets globally. Though India's lackluster economy is not helping at the moment growing at less than 2%, Star India's revenues have grown to $1.3 billion from $570 million about seven years ago. Back on the home front, we like the additional characters DIS will gain including "The Simpsons," "Avatar" sequels, Marvel's X-Men and the Fantastic Four, especially since these personalities don't try to negotiate pay increases the way sports organizations like the NFL and NBA do. Fox's 22 regional sports networks are local cable channels, which have rights to hometown games, and when added to the ESPN package give them more leverage on renewals with pay-tv companies; and importantly, it will add more sports content to ESPN's forthcoming streaming service. With control of Hulu, one of the top 5 streaming destinations for cord cutters, it should give DIS a better leg up to build upon its new streaming services and complement the already announced intention of DIS pulling back important content currently distributed to competitor NFLX.

We will be excited to carefully watch how these new assets develop under DIS leadership. Building direct-to-consumer streaming and content services is increasingly important. We have very high confidence in CEO Bob Iger who extended his retirement date through at least the integration. Of course Warren Buffett has a saying that we dutifully recognize that goes along these lines- he would rather own a great business handled by a mediocre manager than be saddled with a mediocre or worse quality business in the hands of a great manager. We believe DIS has a great CEO, and we recognize the business is facing some challenges. But the company has some of the best entertainment content in the world and has a great portfolio of brands. As the shift in distribution continues to occur, DIS has put itself squarely on track to remain competitive and build the value of its brands such as Star Wars and live sports. If you put in perspective just the $8 billion NFLX plans to spend on content next year and the resources Amazon and Apple will continue to consider investing moving forward, it supports this strategic $62 billion deal. In a speculative sense, it potentially increases the attractiveness of DIS as an acquisition target in the eyes of at least one of these three.

2018 Ahead and 20 Year Anniversary Thoughts

The U.S. and global economic outlook remains bright, and portions of the tax reform will also help moving forward into 2018. The stock market performance during the previous two years has been very strong, so it reflects the strength of the economy. A globally strong consumer demand environment (potentially stronger than most believe) coupled with the continued disruption and new innovation in the economy will continue to favor those businesses that are leading, and leave behind those that lag. We are a huge fan of innovation and productivity; we are long term believers that the short term pain from jobs lost from these two factors always yields better jobs and standards of living for future generations. From our earlier example do you think it's more fun to be a GOOG employee or a door to door encyclopedia sales person? Think of how much more exciting information a young person, properly guided, is getting at their fingertips from the internet versus the back-breaking work of the heavy printed books.

Besides our own collection of businesses and other potential candidates, we always have a few watch points going into the New Year. We continue to be laser focused on the direction of a business' economic moat and observe its current path of profitability and organic growth. If we were to opine where the vulnerability may reside it would be in the types of businesses that continue to have their business model disrupted, and possibly with companies whose higher stock valuation have been supported mostly by low interest rates. Examples of the former include some retail companies including businesses we formerly owned such as Bed, Bath and Beyond (BBBY) which continues to decline as a result of the shifting consumer retail landscape and Blockbuster, which became obsolete when NFLX began shipping DVDs to your house. If the economy grows at a strong rate and interest rates rise, equally vulnerable are companies whose earnings growth has been essentially muted for the last decade and may still be going forward, yet have had an attractive dividend yield. Various food and consumer product companies such as Procter & Gamble (PG) and General Mills (GIS) have barely grown their net income over the 10 years though their valuations (multiple of earnings and cash flow) are at high levels because their dividend payouts are very valuable. Many of these stocks have dividend payouts yielding 2.5% to 3% based on their current stock price. That is still attractive relative to the fixed interest rate on their bonds and the 2.43% 10-year U.S. Treasury yield. For high valuations to continue for these stocks it would be best that their earnings grow and the dividend payout increases as well. If their businesses lag a stronger growth scenario for the economy, then they can get left behind. If the economy otherwise continues to grow in low gear, these higher-yielding lower growth companies may just tread water. Keep in mind these are only observations as we never predict.

SEM's portfolio of high quality businesses grew its earnings in the low to mid-teens during the last two years and the outlook for 2018 is similarly positive. SEM's portfolio appreciation in 2017 recognized the advance in our earnings for the last two years and made up for our portfolio's lackluster stock price performance in 2016, at which time the stock market was mostly event driven (Brexit, the U.S. election) versus fundamentals driven.

The stark disconnect of our returns versus the market during the last two years painted against the backdrop of our since inception results of outperforming the market (independently verified results) while taking less risk should confirm our comments. Throughout our 20 year history the market is often driven in the short run by emotions versus intrinsic value growth in the long run. Intrinsic value growth of the businesses in our portfolio is what ultimately generates the increased value in your portfolio over the long run.

We have the confidence in our process to repeat the relative results while continuing to aim for less risk for the next 20 years. Importantly, we get the most joy out of growing our clients' capital over the long run and seeing them eventually put to use for their retirement or to support their families and charities in need. We also fight disappointment when we lose a client that may have only spent a short time with us, such as in 2016, and made an inexperienced judgment.

The longer you are with us the more you understand we are with you in every way and for a lifetime, if you wish. We take ownership of our decisions in our clients' portfolio, knowing we will not be right 100% of the time but enough of the time to create good results. We eat our own cooking as our company profit sharing plan and much of our personal investments are in the same exact companies. We have also grown and are proud of our team that serves you. We broadened the guidance and advice we can bring to our clients.

Most of all after 20 years we are so grateful to you and all of our clients for your support and confidence. We look forward with great long term optimism and with every hope that over the next 20 years we can generate similarly good results. That means that in 2037 we could potentially tell our clients that we grew $1 million into $25+ million over 40 years!

Thanks as always for your support and best wishes for a healthy, prosperous and peaceful 2018.

Sincerely,

Don	*Amy*
Donald R. Jowdy	Amy Lord, CFA
President	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 (2017)	+30.9%	+21.8%	$ 1,308,800	$ 1,218,300
Three-Year	+9.7%	+11.4%	$ 1,319,200	$ 1,382,900
Five-Years	+14.6%	+15.8%	$ 1,977,100	$ 2,081,400
Ten-Years	+8.6%	+8.5%	$ 2,291,100	$ 2,260,300
Inception (20 Years)	***+8.8%***	***+7.2%***	***$ 5,366,900***	***$ 4,013,500***

* 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