Suncoast Equity Management, LLC

April 4, 2018

Dear Client:

Fears of a global trade war erased earlier gains in the stock market for the first quarter of 2018. The SEM client account composite closed the quarter + 2.6% versus - 0.8% for the S&P 500. It was a roller coaster quarter for equities as the market reached +8% at the end of January, erased all that gain just two weeks later, fought back to +4.5% in early March, only to end the quarter negative. The price action of the markets this quarter should convince you, if you don't already believe, that it is impossible to guess or "time" the short term price movements of the market. In fact, volatility has increased dramatically compared to 2017 when the S&P 500 had only 8 days with a move of 1% or more compared to 23 days in the first quarter of 2018. Importantly you don't have to rely on guesswork to be a successful investor long term. Since the Trump administration's actions on tax reform followed by two separate trade tariff announcements were responsible for most if not all of the volatility this quarter, we review the possible impacts both positive and negative and the tweaks in our portfolio as well.

<u>Portfolio update</u>

During the quarter we reduced our position in **Lowe's** (LOW) and slightly increased our portfolio weighting in **Adobe** (ADBE) and **Facebook** (FB). Portfolio decisions are relative and driven by company specific data points. As the business data points for ADBE became more positive while those of LOW weakened, we wanted to own relatively more of ADBE and being fully invested, we needed to sell a portion of LOW.

As we seek to own growth businesses we identify companies that can grow revenue organically from greater demand for their products and also improve profitability, which can come from various factors. Growth in both forms drive the net income of our businesses and consequently their intrinsic value to consistently higher levels. Ideally we have both, but sometimes end up with only one of these value drivers.

Following the LOW company update and outlook in late February, we reduced LOW to a below core portfolio weighting. The organic growth outlook for LOW remains solid with same store sales in the 3-4% range and a very supportive pent-up demand environment for housing needs. When we made our original investment we were hoping for ample operating margin improvement from two sources, better execution within the U.S. as well as bringing RONA's margins up to par with LOW margins. RONA is LOW's Canadian home improvement retailer, which was acquired in early 2016. While LOW still expects the profitability of RONA to double over the next five years, management has acknowledged execution issues in the U.S. Our execution concerns were validated when CEO Robert Niblock announced his resignation late in the quarter and the stock rallied 6%. It is also possible the company is facing some heightened competition in a few product categories. The earnings outlook for this year and an early peak into next year is still solidly in the low teens. We will continue to monitor the company with the hope that we increase our position back to core if execution improves and competitive issues abate.

ADBE posted another positive report and recently announced it will institute its first price increase since it moved to a subscription model for its *Creative Cloud* marketing software product. *Creative Cloud* is attracting new customer profiles, expanding geographically and increasing features and offerings within this product. Its subscriber base, now 6+ million, is growing beyond the traditional design users to emerging markets such as China, South Korea and Southeast Asia, which are boosting overall subscription growth.

We discussed in our January letter the remarkable rise of some very large businesses like FB and **Alphabet (Google)** due to the network effect and their economic moats. But with success comes responsibility and challenges due to additional expenses required to support these mega enterprises. So when the news recently reported that in 2016 data analytics firm Cambridge Analytica improperly accessed data from FB's platform on tens of millions of users, that was a new discovery. But the point that FB needs to make improvements in data security was not new. Importantly, FB had already taken steps to improve user privacy and prevention of a future Cambridge-like event. The Cambridge event led to a stock price decline late in the quarter in excess of 10% and led to an attractive opportunity to slightly increase our weighting. While it is possible FB will incur some user loss from its base of 1.4 billion daily active users, we believe the value of the network in the world's largest social media community will remain very strong. Despite previous events like inaccurate statistics on ad impressions and inappropriate content being displayed, active daily users have grown from 54% to 66% and the number of users has grown five-fold since 2010. We therefore believe it is unlikely a new network would emerge to replace FB and even if it did it might face similar growing pains.

Data protection, privacy and transparency are understandably very critical issues. As users of FB value the platform to stay in touch with others including family, friends and colleagues on a global scale, would they pay a monthly fee to get a "better experience" with less intrusiveness? Could we possibly see FB initiate a subscriber fee in the future to better serve and protect the direct needs of its users? The path could be similar to how TV originated as a free service supported by advertising in the 1940s and later evolved into users paying cable subscriptions and now Netflix subscriptions. It can start out to be a low fee, similar to the 99 cents Apple charges many users monthly for cloud storage fees. What would 2 billion monthly FB users pay for FB? In the U.S. the average cable subscriber pays over $100 per month and Netflix adds another $10+. With 2 billion users, if FB decided to charge $1 year per user then gradually raised it to $5 per user per month, subscription revenue could begin at $2 billion and grow to $120 billion, compared to FB's current run rate of $50 billion in annual revenues.

<u>The Good, Bad and the Trump!</u>

While the market may have risen early in the year as companies gave a positive read on how corporate tax reform would impact their bottom lines, it gave it all back and went negative as President Trump set in motion a second round of trade tariffs aimed at China. As we welcome the reduction in corporate tax rates to a more competitive global level, we are hoping cooler heads will prevail and we won't get embroiled in a major trade war that would likely lead to a slowdown in economic confidence/growth, rising prices and less shared global innovation.

The first announcement came in early March as part of Trump's "America First" plan, where he announced penalty tariffs of 25% on imported steel and 10% on aluminum, all under the guise that it threatened national security. He lobbed an even bigger threat on March 22 of an additional 25% tariff of $50-$60 billion on imports (roughly 10% of the $500+ billion imported from China last year) and tighter restrictions on acquisitions and technology transfers again aimed mostly at China. Regarding the steel and aluminum tariffs, the Trump administration has dialed back some of the proposal by telling Congress that the European Union, Australia, South Korea and other nations would join Canada and Mexico in gaining an initial exemption. China said it would retaliate and immediately announced it may raise some tariffs on U.S. pork, aluminum and other imports, which make up about $3 billion of goods. We will continue to monitor the early stages of a possibly escalating trade war with no ability to predict the outcome and evaluate the developments as they unfold.

Tax reform lowered the corporate tax rate in the U.S. to 21% from 35%. During the first quarter, company managements shared the positive calculations and what it means for their business' net income. As analysts adjusted their earnings estimates accordingly, we share the before and after outlooks:

2018 Earnings Growth Estimates

	at December 31st , 2017	at March 31st, 2018
SEM	12.8%	18.4%
S&P 500	8.7%	13.6%

Per Reuters

In the table above the earnings estimates at December 31st are pre tax reform, while the March 31st estimates include management and analysts' estimates after factoring in tax reform. While managements do the best they can to estimate and then the analysts of *Wall Street* interpret, we can conservatively assume there may be a little optimism in these numbers. Regardless, a lower tax rate will have a very positive impact on earnings.

Due to tax reform, we made an earlier than normal commitment to add 2019 earnings estimates to our worksheets. We usually add estimates for the upcoming year to our spreadsheets in the late summer to early fall, as the market is forward looking and as the path of the economy going into the following year starts to take shape. Our reason for adding 2019 now is to observe the ebb and flow of changes as a result of tax reform's impact. A first look has our earnings growth going back to a more normal pattern of +12% and +7% for the S&P 500, implying our historical pattern of earnings growth in the low double digits at a level of 30% to 50% higher than the market.

Tax reform has a permanent positive impact on the intrinsic value of our companies until it doesn't, or when it is potentially legislated away by a future administration. As such, we would quantify that lower corporate taxes will add about a year's worth of normalized growth to the intrinsic value of our companies. While the timing is debatable of the stock market's recognition of tax reform, it is our experience that the market looks ahead and not in the rearview mirror. With continued economic strength and a boost from tax reform supporting higher levels of intrinsic value for our companies, we believe our portfolio is at fair value with attractive growth prospects.

Spring ahead!

Toys "R" Us made it official and filed for bankruptcy. The company was ruined by a balance sheet stacked with debt, courtesy of Bain Capital taking the company private in 2005 and the changing retail landscape or the way consumers buy toys for their children. A few journalists applied ink to paper (or the internet) to lament the loss of the Toys "R" Us shopping experience or the tradition of taking their children to the store. Yes, it's not the first lost tradition and it will not be the last either. Does anyone else remember as a kid looking through every page of the Service Merchandise store catalog trying to convince mom and dad to buy all the things we wanted for Christmas and ranking them accordingly? Or fast forward to today, how about going to the shoe store in the mall to try on new running shoes and make sure they're comfortable versus buying shoes directly from **Nike (NKE)**? At NKE direct to consumer sales grew 18% this quarter against a backdrop of global revenue growth of 6%.

Of course one can miss those simpler times and traditional shopping experiences. Some have taken it a step further asking if we are becoming robots, influenced by social media manipulation (fake news) and lost traditions. While traditions hold great memories and some are indeed lost, new ones are discovered and begin. With any new technology, positives and challenges abound. As I strived towards a better living to find work that supported my passion and skill set, I moved away from the place I grew up 25 years ago and had to leave family and friends behind. That was not easy and it was before there was Facebook. Services like Facebook have allowed us to stay connected to our families and reconnect with old friends. So for all the apparent "evil" cited by some journalists and others…the good does indeed lie underneath.

Even though the progress of mankind is inherently uneven, it has over time been nothing short of positive. Warren Buffett noted in his recent shareholder letter that "In 100% of the 43 ten-year periods since we took control of Berkshire, years with gains by the S&P 500 exceeded loss years." Likewise over our life-long journey of saving and investing we will live through many economic events. When Britain voted to leave the European Union in June 2016, that event caused immediate uncertainty and cast a dark cloud over global economic growth. Nearly two years later it is in the rearview mirror and barely a memory as not only has U.S. economic growth been solid but so too for the U.K where the number of people working stands at a record high. Back at home, February durable goods (products designed to last 3+ years like industrial robots and refrigerators) rose 3.1% which was the largest gain since June 2017. While we have our concerns and hope that an international trade war does not escalate, we know businesses will adjust and persevere.

The earnings outlook for 2018 for our portfolio companies looks robust, in part because of tax reform. We will continue to execute the **SEM-DIS** (Disciplined Investment Process) for relative value and selection. 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 (2018)	+2.6%	-0.8%	$ 1,026,300	$ 992,400
One Year	+23.4%	+14.0%	$ 1,233,500	$ 1,139,900
Three-Year	+9.9%	+10.8%	$ 1,328,600	$ 1,359,500
Five-Years	+13.1%	+13.3%	$ 1,846,300	$ 1,867,500
Ten-Years	+9.6%	+9.5%	$ 2,504,400	$ 2,477,100
Inception (20 1/4 Years)	***+8.8%***	***+7.1%***	***$ 5,508,200***	***$ 3,983,000***

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