SUNCOAST EQUITY MANAGEMENT, LLC

October 1, 2018

Dear Client:

The SEM portfolio posted solid results for the year through September 30th, +15.6% versus the S&P 500 +10.6%, reflecting the continued strength of the U.S. economy and earnings growth, aided meaningfully this year by lower corporate tax rates. Meanwhile, volatility remains active as trade and tariff discussions with China, in particular, and investigations top the headlines. We added one new company to our portfolio and share some thoughts about recent business trends towards subscriptions replacing ownership.

Portfolio update

Portfolio activity was minimal in the third quarter though we welcomed back **Apple (AAPL)** in August. Much like our purchase of **Microsoft** last quarter, we sometimes step back into a position we've held before when a company regains business momentum and maintains strong financials. For now, the iPhone continues to generate the majority of AAPL's revenue and the company has just rolled out three new phones to mostly positive reviews. Although unit growth may be minimal, AAPL is focused on the worldwide high end smartphone market and appears to have pricing power in that segment, but its fastest growing division is Services with more than 300 million paid subscribers. Services include the App Store, Apple Care, iTunes, Apple Pay, online storage and cloud services, as well as licensing fees. In fact, Services revenue has doubled since 2015 to 18% of total sales or a run rate of $36 billion, which would rank it in the Fortune 100 if it were a stand-alone company.

In investing, years of experience are very valuable as it helps you relate previous analysis to today's companies. Let's bring in an old favorite of ours, Gillette. We are in agreement with Warren Buffett's recent comments about AAPL, and additionally we consider Apple to be parallel to Gillette as they are both consumer product and service companies, versus most of the investing public that labels AAPL as solely a technology company. The business models of Gillette/AAPL are similar and can be thought of as selling razors/iPhones (also Watches, Beats, etc) and more profitable razorblades/Services.

The Services business for AAPL is a long term catalyst, as it strengthens in value to its customers it also strengthens AAPL's ecosystem and intrinsic value by generating more consistent and growing income. With Gillette, we owned it many years ago and sold it only when their price increases outpaced the value they were adding. We believe Apple's ability to add value with Services (razorblades) is expanding and is in the early innings. For example, AAPL received FDA approvals for its Series 4 Watch launched on September 21st for atrial fibrillation (a-fib) detection and an electrocardiogram (ECG). The Watch can also detect a hard, sudden fall. It taps your wrist and sends an alert, so that you can dismiss it if you're ok. But if not, it calls for emergency help. We believe these new features are just the beginning as AAPL expands further into healthcare and the automobile sector with artificial intelligence (AI). Income streams in AAPL's service segment are quite diverse. Did you know that when you do an internet search on your iPhone in the Safari browser, more often than not it is accessing Google's search? It does and GOOG shares digital advertising revenues with AAPL, which is a significant amount that at last report was $2.5-$3.0 billion or 5-10% of its Services revenue.

With any business there are items to pay attention to, even companies that are new to the portfolio. We don't expect iPhone (razor) price increases to be a long term driver, but we have a strong conviction in the Services (blades). AAPL has also lost market share in China, a very important market for the company, and that among a few other factors were at the root of our decision to sell it a few years ago. AAPL's net income reached $53.4 billion in fiscal year 2015. During our absence as owners, net income declined to levels in the $46-$48 billion range in the following two years until getting back to an estimated level of $55+ billion this fiscal year ending September 30th. We believe the Services business has been an important factor in the improvement. While market share has not improved in China, we believe it may be stabilizing and that AAPL will remain a premier brand for citizens of that country, too. We look forward to increasing our position to a core weighting in the coming quarters.

In other news, software industrial leader **Honeywell (HON)** announced last year that it would spin off its Transportation and Home units into independent companies by the end of 2018. In September, HON slightly increased its 2018 adjusted earnings target and offered more details on the spinoffs. The Transportation unit is now **Garrett Motion (GTX)** with $3.1 billion in annual revenues, specializing in software solutions that help monitor vehicle performance, health and cyber-security. GTX began trading on October 1st and shareholders received 1 share of GTX for every 10 shares of HON they own. **Resideo Technologies (REZI**) with $4.5 billion in annual sales is a leader in IoT (Internet of Things) for homes and a distributor of critical comfort and security solutions mainly for residential settings. REZI is expected to begin trading in mid October. GTX and REZI will pay a $3 billion one-time dividend to HON, which management plans to use to pay down debt and buy back stock. Typically businesses that are spun off have immediate success as they are more focused on unlocking intrinsic value as a stand-alone company. We will determine if they are worth holding as small positions or if we should redeploy the funds into our other holdings over the next few quarters. After both spinoffs are complete, HON will be more focused on high growth industrial sectors which are aligned with global long term trends of energy efficiency, infrastructure investment, urbanization and safety.

<u>Rent, never an owner be?</u>

As we've often discussed, businesses are living, breathing organisms that change over time. One global business trend that is gaining momentum for both consumers and businesses alike is the transition to renting products and services for a monthly or annual fee, from buying or owning previously. The iTunes Store (iPod) grew to success by allowing users to purchase individual digital downloads (vs. physical records or CDs) and now offers a library of 45 million songs via a monthly subscription. Additional commonly known successes of today are Netflix charging a flat fee vs. renting movies from Blockbuster on CDs or VHS tapes, Amazon Prime and cloud storage for services such as storing photos for consumers and data for businesses.

Author Tien Tzuo, who just published "Subscribed: Why the Subscription Model Will Be Your Company's Future-and What to Do About It," captured it well. For customers, subscribing allows access to the most current, relevant, and secure data or service. For businesses it gets so much better as it allows access to real-time consumer behavior that is much more valuable and efficient than waiting for their employees to give feedback on customers' preferences.

Today it is stretching across many product categories and industries from large to small, autos to musical instruments. While we were familiar with Cadillac and Volvo's programs that entice you to pay a flat monthly fee, which allows you to switch cars within a one year time frame and includes insurance and taxes, it was interesting to learn as Tzuo shared how guitar maker Fender is trying to keep its customers engaged and coming back for more. As Fender sells almost half of its instruments each year to new guitarists, it learned that 90% give up playing within a year; so Fender started Fender Play, an online teaching service, to keep the dreams going for aspiring musicians. Fender understands that "the subscription cultures are about making sure your customer continues to succeed with your service over time, and translating that ongoing value into revenue."

In addition to Apple, several of our businesses have embraced the shift and are seeing more consistent revenue and long term profitable earning streams. **Adobe (ADBE)** began shifting from a licensing model to a subscription model about five years ago and is now considered the poster child of success. **VMware (VMW), Check Point Software (CHKP)** and **Microsoft (MSFT)** are also well into the transition. Even **Starbucks (SBUX)** and **Nike (NKE)** to a certain extent have embraced the concept of knowing your customer so well through real-time transactions with Starbucks Rewards and NikePlus Membership that you can create new drinks or shoes with a much higher degree of confidence based on the secure identity you've established with them. That identity includes buying patterns, payment details, demographics and possibly even location alerts. We believe these trends strengthen the ecosystems or economic moats around these businesses compared to those that just sell products and know very little about their customers. The subscription model is a creative way to improve a company's economics, though not all will be successful and we can envision some "subscription fatigue" potential developing eventually. Plus early forms will evolve, especially in such significant areas as transportation, getting from bed to desk so to speak. Only the future will tell if we move more towards subscribing to a Cadillac or subscribing to ride services where we are merely the passenger. We will continue to observe the trends like these and their effect on our companies.

Fall ahead?

Interest rates remain low but have edged up a bit and the yield curve, the spread between long and short term rates, has flattened. The 10 year U.S. Treasury yield has risen to 3.1% and importantly short term cash is finally earning something as the yield in one-year or less Treasury securities is between 2.4% - 2.7%. We have helped our clients with cash management utilizing treasuries, as finding short term yield is not exactly at your fingertips. You need to know where to look since bank deposits and money market yields, including certificates of deposit at large banks and institutions like Bank of America and Schwab, remain way below treasuries.

The expansion is now in its 10th year and has lasted longer than all but one of 34 expansions since 1854. So everyone is wondering and worried about the next downturn. With market and economic prognosticators filling the space between advertisements on CNBC or Bloomberg TV, and with plenty on both sides of the spectrum, we suggest you ignore them all. Never confuse predictions with certainty. We don't make predictions but we do observe business and economic data points. Consumer confidence, an important economic driver and indicator of future spending, hit a new 18-year high in September. Also, consider that expansions can last longer than ten years; witness Australia that is riding a 27-year run of recession-free growth.

Importantly, we recommend that you ignore market and economic predictions because we enjoy owning our businesses throughout the economic cycle and don't plan to liquidate even if someone gave us tomorrow's headlines in advance and it said the economy is slowing. Our portfolio of businesses tends to gather more strength when we experience economic declines. Perhaps more discussion about this when we get closer to that point in time, as some of our best relative performance occurs during down markets due to our continued ownership of businesses with great balance sheets that generate lots of cash.

This fall, like any period in the future or in the past, there will be plenty of events for folks to worry about (some we know of such as the midterm elections and others we don't) that will impact the market for the remainder of the year. The market will ebb and flow as it always does and our **SEM-Disciplined Investment System** has the path to navigate through. We will keep working hard to preserve and grow your capital and we thank you for your continued confidence.

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
YTD	+15.6%	+10.6%	$ 1,155,800	$ 1,105,600
One-Year	+24.9%	+17.9%	$ 1,248,600	$ 1,179,100
Three-Year	+15.3%	+17.3%	$ 1,531,800	$ 1,614,300
Five-Years	+13.6%	+14.0%	$ 1,888,700	$ 1,921,000
Ten-Years	+11.9%	+12.0%	$ 3,079,700	$ 3,096,200
Inception (20 3/4 Years)	***+9.2%***	***+7.5%***	***$ 6,202,800***	***$ 4,437,400***

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