Suncoast Equity Management, LLC

July 2, 2019

Dear Client:

For the first six months, the SEM client account composite advanced +23.8% versus +18.5% for the S&P 500 index. The gains, so far this year, are in the face of the stormy trade talks that consume the headlines. At the same time, with the economy reaching the longest economic expansion in U.S. history (since the financial crisis in 2008) and interest rates slightly inverted to flat, the talking heads second topic du jour is "when will the economy turn down." Our advantage is that while the investing public obsesses over the uncertainty and the unknowable outcome of trade talks and short term direction of the economy and interest rates, the **SEM-Disciplined Investment System** (SEM-DIS) is focused on owning a small group of high quality businesses and researching new opportunities that are advancing earnings, and consequently intrinsic value no matter the economic environment. We discuss the SEM process for uncovering new ideas, pay tribute to a fellow investor from our Buffett-Graham "intellectual neighborhood" that beat the market for three decades, as we continue in our 22nd year to accomplish a similar path, and of course provide a portfolio update.

Portfolio Update

After owning Accenture (ACN) for several years and watching similar growth drivers develop in entrant **Cognizant (CTSH),** we initiated a position in August 2015. CTSH was generating double digit revenue and earnings with its "two in a box" business model, on-site client service teams paired with offshore global delivery centers. Management expected growth to come from market share gains in its two largest segments, financial services and healthcare, as well as expansion into new geographies, since 75% of CTSH's revenue was from North America. CTSH posted lumpy results the last few quarters and struggled to diversify its North American business. Management also stated last fall it had "made the turn" in financial services with digital growth offsetting less profitable day-to-day functions for its banking clients. However, when its new CEO reported weak results again in May of this year in financial services and healthcare and significantly lowered 2019 revenue and earnings targets, we decided to sell our small position. Accenture, on the other hand, recently reported strong growth in North America as well as financial services and increased its 2019 revenue and earnings expectations.

In June we initiated a small position in **Amazon (AMZN).** Like many of our other companies, AMZN benefits from the network effect, which means the more customers that use its products and services, the more valuable they become. Its powerful global brand and industry leading logistical operations allow it to dominate the online retail market. While this has been building for some time, it is a low margin business. The beauty of it is that it has been accumulating customers and subscribers, with about 120 million Amazon Prime Members. Meanwhile, coming on very strong within just the last few years have been AMZN's other businesses: (1) Amazon Web Services (AWS), (2) third party sellers (Marketplace) and (3) digital advertising, which is what attracted us to the company. All three are gaining momentum and offer much higher margins than retail. For example, *AWS* is the market leader in cloud computing, which is essentially on demand computing power, database storage, and applications with a pay-as-you-go business model. It was originally developed to help Amazon sellers with technology infrastructure and now serves millions of customers including fast-growing start-ups, large enterprises and government agencies. AWS revenues were +47% last year and now represent 11% of total revenues. With a 28%+ profit margin compared to a 5% retail margin, AWS is adding meaningfully to the company's profitability. *Marketplace*, its third party seller platform, generates revenue by charging sellers a service fee to be listed on the platform, usually a percentage of revenue. In return, sellers benefit from the credibility that comes from Amazon's brand name, global distribution, and fulfillment by Amazon or FBA, meaning 1-2 day shipping for Prime members. Revenue from Marketplace was +34% last year compared to Amazon's online stores +14% and it accounts for 18% of total revenue. Marketplace leads us to one of Amazon's newest businesses, *digital advertising,* where third party sellers as well as others can promote their products. Although still a very small percentage of total sales (management doesn't break it out but states that its "other" category is mostly digital advertising), AMZN recently surpassed **Microsoft's** market share in the US digital ad market, sharing the road with **Alphabet (GOOG)** and **Facebook (FB)**. In fact, eMarketer expects Amazon digital advertising to increase 50% this year and represent 9% of the $129 billion market. We will observe the growth in these business lines and plan to increase our position over the coming quarters.

In other portfolio news, **Facebook** announced a major plan to launch a global payments service and product, based on blockchain technology and "cryptocurrency" format, with the given name of "Libra". The organization created by FB and based in Geneva boasts over 27 partners including our portfolio companies **Visa**, **Mastercard** and **Paypal,** which threw in $10 million each to be part of the group. As a consumer you would download a digital wallet from a FB subsidiary called Calibra, which then allows you to purchase Libra, a cryptocurrency that you use to pay for goods and services across the globe. Without getting too deep in the weeds on this, it is secured by blockchain technology (a digital ledger and bookkeeping system) and Libra's value is pegged to a basket of global currencies backed by a reserve fund which will hold mainly government securities. This is a bit of a contrast to recently popular bitcoin(s), which in our view is more speculative and has proven to be very volatile. Bitcoin has a spotty record of processing a large of number of transactions, but supporters see it as a store of value like gold (which in our view has extrinsic not intrinsic value).

FB's focal point with Libra is to serve the 1.7 billion people globally that don't have active bank accounts, but many of which have FB accounts. It will be offered through its Messenger and WhatsApp platforms as well as a standalone app, Calibra. Two related takeaways for us as investors are that big ideas can be powerful when you have network economics and 2.4 billion users, as FB is the largest network of its kind. As part owners of FB we also believe there are likely other services or products FB may think of in the future that it can offer and consequently leverage its unprecedented user base. At the same time these big ideas may not pan out, so we never consider them in our present valuation of the business until they gain some traction. We are eager to watch the progress of Libra as it relates to an opportunity for FB and at the same time cognizant of the competitive threats to other payments companies like Visa, Mastercard and Paypal, who will also be partners in this venture.

While we are on the subject of **FB** and **GOOG,** one additional thought we want to continue to share, is as these two businesses increase their spending, which has recently slowed earnings growth, both have enormous scale and competitive advantages that support our continued ownership at this time. With significant network economics, big new ideas may come to fruition like this recent announcement from FB. That, combined with the current financial strength of the businesses and balance sheets, can be very powerful long term drivers for us as investors.

FB and GOOG's recent spending increases are reasonable and in our view supportive of the long term strength of their business. In our best judgement, FB and GOOG's business issues, including government threats, are mostly growing pains. We have to remind ourselves how quickly these immense businesses have grown. Did you know that in less than four years FB has grown its net income to $22 billion in 2018 from $3.7 billion in 2015? That's a 500% leap in earnings and an incredible achievement in corporate history. Data privacy is a very important subject but it is not limited to FB and GOOG. It embroils all companies from **Square**, which was recently criticized in *The Wall Street Journal* for forwarding a digital receipt from a woman hiring a divorce attorney to a random acquaintance, to Target for recent data breaches. All companies need to carefully handle and improve personal data privacy and to the best of their ability deliver accurate and appropriate information in an era that one recent journalist cleverly deemed the "surveillance economy" (or surveillance capitalism). We would rather describe it as the personalized (or customized) service and product economy. Political motivations and actions by Congress, regulation and antitrust towards successful companies are almost always backwards looking. Those in charge in this realm seem to forget that good old free market capitalism ushers in competition over time. We will keep a close watch on FB and GOOG as we do all our companies, utilizing our best experience to separate the noise from the important business data points.

<u>SEM-DIS New Opportunity Discovery Process, (Why Amazon Now?)</u>

So how did **Amazon (AMZN)** come up for consideration? Why now? Did we have an emotional feeling that we need to own it because it is one of the more popular names among investors that gets daily coverage in business or national papers such as *The Wall Street Journal* or *The New York Times*? Did we buy it because a famous TV business journalist, Jim Cramer of CNBC, popularized the term FAANG (his acronym for Facebook, Amazon, Apple, Netflix and Google) and seems to cover these stocks daily on his show? The answer to both of these questions is no.

The **SEM-Disciplined Investment System (SEM-DIS)** is always closely monitoring a list of companies we don't own and comparing them with what we currently hold. Other than specific attributes we identify above in the portfolio update section, we thought it would be good to revisit with you how a company gets on the farm team list, so to speak. At the end of this letter is the graphic illustration of SEM-DIS which importantly has not changed but evolved since inception.

It begins with the universe of a few thousand companies ranging in size from large to small capitalization businesses. That list quickly narrows to only 10-15% of the total population that meets our ***"high quality business"*** requirements. The high quality criteria demands that each prospect demonstrate a record of: (1) above average returns on capital, (2) consistently earning free cash flow, which is cash in excess of all spending that is revealed on both the income statement and cash flow statement from their audited financials. The SEM-DIS has a third and fourth high quality criteria: (3) we require a strong balance sheet as it relates to the ratio of cash reserves to debt and also free cash flow to net debt. Finally and importantly (4) we prefer growth businesses for the fundamental belief that if a business grows its earnings consistently higher over time, with a well managed amount of capital, its stock price will follow.

As it relates to our purchase of AMZN, it was not until 2018 that it began to demonstrate consistent free cash flow in excess of its spending, though we have been a great admirer of its business for over a decade. We have owned **Alphabet (GOOG)** since 2008 as it met our stringent criteria that far back.

Keep in mind that the few hundred companies that meet the first important criteria is not a static list. Over time new companies may qualify and some existing businesses may make it on the list if their economics improve. Importantly, it is a tough group to qualify for and because the amount of new companies entering each year is a low number; our cumulative knowledge of this group grows and gets deeper over time. Examples of companies today that we continue to monitor but don't meet the free cash flow requirements include well known businesses such as **Netflix** and **Tesla**. In particular, Netflix is still spending much more on new content than it is earning, though we admire its global expansion and business model.

Our next step is to ***"monitor and assess"*** this list of typically a few hundred candidates. Throughout the year we study and review the changes in financial strength (cash flow and balance sheet) and compare it to its history, observe changes in operating and net margins, and monitor the relationship between its stock price and intrinsic value estimate. We created proprietary spreadsheets in which we input important financial information and our **SEM-DIS** valuation metrics to track and compare candidates. As it relates to AMZN, what is so powerful is even as its sales have obviously grown at a fast pace, its operating margin, as defined by the Value Line database we utilize, leapt to 12% from 8% and 4% in 2018, 2015 and 2011, respectively.

The SEM-DIS requires we conduct ***"in-depth reviews"*** on the businesses we currently own and on our prospect list. We look for competitive advantages of (and threats to) the business, market and product growth and operational scale as well as management skills (see attachment below). To repeat what we mentioned above even if we pass on a new idea after an in-depth review, we continue to monitor it so that we gain knowledge and perspective for comparison to our other businesses and prospect list. Our comments about our AMZN purchase above in the portfolio update section capture some of our qualitative review observations.

Finally, we ***"select and manage"*** our new portfolio holding. We initiate a position, as we did with AMZN, opportunistically when the stock market softened in early June, and then we increase the portfolio weighting over time.

<u>With Respect</u>

As you have heard us say before, we are students of what we believe to be a very sound framework for successful investing that is both common business sense coupled with a high degree of emotional intelligence. Of course our founding fathers, so to speak, are Warren Buffett and his mentor Benjamin Graham. Like all good college basketball coaches that followed in the footsteps of Dean Smith of North Carolina, there are many of us that come from the "intellectual village" of Warren Buffett and Benjamin Graham. The primary principles are to: (1) mindfully think of being an investor in stock as being a part owner of a business, (2) incorporate margins of safety and (3) understand that the market is there to serve us the investor. Many of us from the village have successful track records by applying these principles within our process, which we define as **SEM-DIS** and we cover above.

We respectfully pay tribute to one of the members of this group Mr. John Neff, who recently passed away at 87. He was inspired as we are by Ben Graham's writings and books. Early in our careers, we would often read Mr. Neff's letters to investors both current and historical, as he traversed the markets including the "go-go" 1960s and "nifty fifty" market of the 1970s. For over three decades, from 1964 to 1995, at Wellington Management's Windsor Mutual Fund Mr. Neff achieved a 13.9% annual rate of return versus 10.6% for the market. A $1,000 investment in his fund grew to $56,000 versus $23,000 for the S&P 500, per a recent honorary article in *The Wall Street Journal*. Over this 31 year span, Mr. Neff and Windsor delivered added wealth value over the S&P 500 of 143% with **active management**. In SEM's first 21½ years, our active management added wealth value is 48%. Our added wealth is meaningful, though it could lag Mr. Neff's when we get to the 31 year mark because of stock market's significantly lower (but still acceptable) annual average return of 7.3% versus 10.6% during Mr. Neff's tenure. With another decade of compounding to go to mark a similar time period as Mr. Neff, we look forward to continuing to add to our results, relative and absolute, and have every hope of going further and creating a successful 40+ year track record.

Best wishes for a great summer. 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 Six Months (2019) | +23.8% | +18.5% | $ 1,238,300 | $ 1,185,400 |
| One Year | +14.6% | +10.4% | $ 1,146,300 | $ 1,104,200 |
| Three-Year | +18.4% | +14.2% | $ 1,659,100 | $ 1,488,900 |
| Five-Years | +12.4% | +10.7% | $ 1,792,600 | $ 1,663,300 |
| Ten-Years | +14.8% | +14.7% | $ 3,965,800 | $ 3,941,600 |
| ***Inception (21 1/2 Years)*** | ***+9.3%*** | ***+7.3%*** | ***$ 6,721,800*** | ***$ 4,548,900*** |

* 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

**Suncoast Equity Management, LLC**

# SEM Investment Process

| | |
|---|---|
| **3,500** Stock Universe | **Identify High Quality Businesses**<br>▪ Strong ROIC<br>▪ Low Debt / Capital<br>▪ Low Debt / FCF<br>▪ Free Cash Flow Positive<br>▪ Growing Businesses |
| **300-400** Candidates | **Monitor & Assess Primary Candidates**<br>▪ Financial Strength Review<br>▪ Consistency (Historical 5 to 10 years)<br>▪ Operating & Net Income Margin Trends<br>▪ Valuation Review |
| **100-125** Coverage Universe | **Select & Conduct In-depth Financial Review**<br>▪ Product, Services and Franchise Strength<br>▪ Competitive Advantages & Barriers to Entry<br>▪ Operational Advantages (Advantages of Scale, Low Cost Producer)<br>▪ Sustainability (Over the Next 10 Years)<br>▪ Management-Owner Oriented, Candid & Communicative<br>▪ Valuation - Relative & Absolute |
| **15-25** Portfolio Holdings | **Portfolio Selection & Management**<br>▪ Concentrated Portfolio<br>▪ Business Momentum & Development<br>▪ Margins of Safety Remain or Build Strength<br>▪ Portfolio Weighting Emphasis on Best Performing/Best Value |