SUNCOAST EQUITY MANAGEMENT, LLC

October 2, 2019

Dear Client:

The SEM portfolio and the markets are holding on to strong gains so far this year, albeit below the highest levels, with our portfolio up +25.5% versus the S&P 500 +20.6% as of September 30th. While the market gains thus far are a direct connection to earnings gains achieved this year and last year (when the market was down 4.4%), concerns are growing louder about a possible recession ahead. Public concerns for an economic slowdown have been growing for at least a year now, and as we mentioned in our October 2018 letter, "animal spirits" can be impactful. We discuss a bit more about how our SEM-DIS, regardless of the economic backdrop, identifies growth businesses in an always evolving environment of disruption and innovation. We also cover a few thoughts on our companies that have their hands full from global government scrutiny. There were no changes in the portfolio this past quarter.

<u>The Disrupters vs the Disrupted; Value Investors buying Growth Businesses</u>

We are often asked how we know which businesses will create and lead new disruptive technologies in the future. The short answer is we don't. We can't predict the "next new thing" or speculate on which companies will create massive profit from a new technology or innovation, and yet we don't need to. Rather, the **SEM-Disciplined Investment System** (SEM-DIS) leads us to them as their economic profits and financial strength excel, which we covered in depth in our July 2019 letter in our new opportunity discovery process.

As new disruptive technologies emerge and are applied to commercial and consumer applications, we observe how our businesses apply blockchain, artificial intelligence (AI), 3D printing, Internet of Things (IoT) and robotics. As discussed in our previous letter, **Facebook (FB)** plans to use blockchain technology to launch its digital currency Libra, to the 1.7 billion people in the world that don't have active bank accounts. **Nike (NKE)** is using 3D printing to manufacture performance footwear, which not only tailors each shoe for its customers but minimizes logistics and inventory management. Darius Adamczyk, **Honeywell (HON)** CEO, recently discussed their "dark warehouses" which use industrial robots to automate manufacturing plants for their clients. **Amazon (AMZN)**, the poster child of disruption, started as a bookseller and basically created the $200+ billion global public cloud market, now its most profitable line of business.

In this era if you are not disrupting, you are being disrupted. A recent article in *The Wall Street Journal* by James Mackintosh highlights disrupters. Mackintosh suggests, and we agree, that growth businesses are better positioned to take advantage of new waves of technology relative to disrupted businesses that can't afford to make those investments due to less internal cash flow, low valuations and tighter banking standards since the financial crisis. New research found that since 2007 "value" companies had the weakest profitability since 1970 while high growth companies had their best profitability. We've always felt value and growth are two sides of the same coin, meaning we are in search of growing businesses that are selling at less than their intrinsic value. We consciously balance our portfolio between growth and safety businesses, defining safety as having less chance of business model disruption. For example, companies like **NKE** and **HON** meet the criteria due to their financial strength, market leading innovation and global distribution. Meanwhile growth businesses like **Alphabet/Google (GOOG)** not only have the financial strength to invest in disruptive technologies but can leverage those investments, whether it is self- driving cars using AI and IoT or a market leading chat app in India, Google Pay, with 180 million downloads. Users in India are buying train tickets, paying bills and buying lunch from street vendors in local languages using Google's digital payments platform. As always, we will observe how these data points affect our other holdings like **Visa (V)** and **Mastercard (MA).**

SEM's comfort zone has always been as a value investor buying growth businesses for the long term; we have never been a value investor buying deteriorating businesses. In today's innovative and disruptive economy, it is our preference to avoid declining businesses no matter how cheap the price. We have executed the **SEM-DIS** for over 20 years, so having that many years of experience is an advantage. At the same time, the opportunity to learn, grow and better execute never ends. To make good decisions with the best possible clarity, you need to remain humble, since businesses will change over time as their competitive advantages expand and contract.

A case in point from our portfolio exemplifying a safety and growth business is **Nike**. When we first bought NKE in 2006 we paid $10.38 a share for $0.66 in earnings, or an earnings yield of 6.3% (earnings divided into the price) and 15.7x price to earnings ratio. After observing its economic moat in athletic footwear and apparel we had a high level of confidence that its earnings and intrinsic value would expand in the years to come. After 13 years of ownership and a recent strong earnings update, NKE will earn nearly $3.00 per share during this fiscal year, +19% vs last year. Based on our original cost $10.38 per share our earnings yield is now a whopping 28.9%, or 3.5x price to earnings ratio. The strong growth for NKE is driven by higher margin international sales, direct to consumer and digital growth, as well as market share gains in women and kids. Management highlighted 22% revenue growth in China this quarter despite tariffs, currency headwinds and geopolitical tension. We believe it is possible to find and own select growth companies during uncertain and even difficult economic environments.

While our process keeps us focused on the most profitable businesses, oftentimes disruptive technologies are not so profitable at first or even for long stretches despite offering a valuable product or service. Innovative companies like **Netflix (NFLX), Tesla (TSLA), Uber (UBER)** and most recently **WeWork** lack consistent profitability and most are cash flow negative (spending more than they take in). We respect these business models and will watch their data points as possible candidates for the portfolio, but they do not qualify for our discipline at this time.

<u>All Hands on Deck</u>

Facebook, Google, and Amazon continue to face scrutiny from government agencies for possible monopolistic business practices. Whether it's the FTC, state regulators in the U.S. or EU antitrust, we continue to watch these developments brewing at home and overseas in Europe and places such as India. Our viewpoint is that free market competition is better suited to introduce new entrants versus regulation when competitors offer more attractive products and services. These three companies as well as other global businesses we own such as **Microsoft (MSFT)**, have gained significant competitive advantages in their marketplace. Of course that is why we own them. **GOOG** and **FB** garner 57% of all digital advertising in the U.S. according to eMarketer, and they achieved that by driving measurable results for their clients. Although it has not been a perfect path of execution for GOOG and FB, these businesses beat back competitors such as Yahoo or Tumblr, which at its apex had more users than Instagram. Over the last decade as FB and GOOG became successful outpacing additional competitors in their respective fields such as Myspace and MSFT Explorer, they hired great talent and purchased related businesses to enhance their value proposition and deliver better service.

As we have talked about before, there will be growing pains. When you have fast growing companies offering any kind of digital information service, privacy and safety are important issues. But we believe if anyone is going to get it right, it will be the companies with financial strength as it is incumbent on them to deliver a better service to their clients or face new competitors that will. Regulation is nearly always backward looking and may actually strengthen the already established companies like it did with GDPR (General Data Protection Regulation was instituted in May 2018 by the EU) rather than open the market to new competitors. We recognize that government inquiries and new regulations can distract a company from its primary business, as it may have affected MSFT for many years. So far the demand for GOOG and FB services remain robust and the financial impact to our companies has been minimal. We will continue to observe the government scrutiny and be mindful of the impact on our businesses.

How Low Can We Go? Advantage of Financial Strength

Interest rates fell dramatically in the third quarter with the 10 year Treasury bond hitting a low of 1.47%. Higher tariffs are fueling the global slowdown, which has led to $15 trillion of negative bond yields around the world. Although current Treasury rates don't even offset inflation, they are in a relative sense more attractive than other major economies' bonds. Investment grade corporate bond yields are near their lowest levels since the 1950s. **Apple (AAPL)** took advantage of low rates and issued $7 billion in bonds including a 30 year bond at 2.95%. With $103 billion in net cash ($211 billion in cash less $108 billion in debt) AAPL doesn't need the money. But management believes by buying back shares or reinvesting it in the business they can earn a higher return than the 2.95% coupon they will pay their bondholders. Balance sheet strength is paramount to our process and the **SEM-DIS** requires the ability to pay off all debt within a 4 year or less time frame. While we prefer cash over debt, with nearly half our companies flush with cash, we can tolerate some leverage due to the consistent cash flows of our businesses.

Another holding with tremendous financial flexibility is **Microsoft,** one of our larger positions and faster growing companies. The company recently announced a $40 billion share buyback and increased its dividend by 11%. The media made a big deal out of it but we view the buyback allocation as business as usual, since there is no specific timeline for completing it and it only represents 4% of the company's market capitalization. Interestingly, MSFT spent $19.5 billion on share repurchases in it last fiscal year ending June and it is the most the company has spent on buybacks in more than a decade. MSFT is generating so much extra cash that buybacks have consumed nearly half of its free cash flow over the previous five years. As shareholders we appreciate this return of capital to us if cash generation is in excess of available internal projects or expected returns from an external investment such as an acquisition.

Navigation ahead

For sure it was an exciting quarter with low and volatile interest rates, the initiation of a presidential impeachment inquiry and an attack on the Saudi oil manufacturing complex. While the U.S. economy remains fairly strong, there are pockets of weakness at home and struggling economies around the world. Additionally, trade disputes between China and the U.S. are having an impact on many U.S. businesses, except **NKE** at present as we highlighted above. Every economic downturn is different as some are triggered by financial crisis such as the global slump a decade ago and others are just a mix of weakened demand. As John Maynard Keynes, the British economist characterized while "animal spirits" can have an important influence and economies are held together by shared expectations, at the heart of the economy is consumers' behavior.

Assuredly there will be more turbulence ahead. Nevertheless, the SEM-DIS will always do its best to navigate through any potential economic slowdown the same way it has through numerous previous experiences, by owning companies through the economic cycle with great balance sheets and abundant cash flow characteristics. Our portfolio, though it has temporarily suffered price declines, has never experienced an overall earnings decline. Over our nearly 22 year history, our lowest portfolio earnings growth occurred in 2009 at a rate of approximately 5%, as compared to our long term average between 11%-13%. We believe as our businesses grow their intrinsic value, their stock prices will naturally follow over the long run.

Thank you for your continued confidence, and we will keep working hard at preserving and growing your capital.

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

<u>Time Period</u>	**SEM <u>% Return*</u>**	**S&P 500 <u>% Return</u>**	**SEM - Value <u>of $1,000,000</u>**	**S&P 500 - Value <u>of $1,000,000</u>**
YTD (9 months)	+25.5%	+20.6%	$ 1,255,000	$ 1,205,500
One-Year	+9.8%	+4.3%	$ 1,098,300	$ 1,042,500
Three-Year	+18.2%	+13.4%	$ 1,650,600	$ 1,458,000
Five-Years	+11.7%	+10.8%	$ 1,735,900	$ 1,672,700
Ten-Years	+13.6%	+13.2%	$ 3,591,800	$ 3,467,400
Inception (21 3/4 Years)	***+9.2%***	***+7.3%***	***$ 6,812,300***	***$ 4,626,200***

* 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