SEM

SUNCOAST EQUITY MANAGEMENT, LLC

January 3, 2020

Dear Client:

SEM and the overall market recorded very strong returns for 2019, with the SEM composite performance notching +35.7% net of fees, versus the market of +31.5%. As for any annual review, there is both reason for caution and optimism. The economic slowdown and changing market tastes in large markets like China as well as the shift at home towards "stakeholder capitalism" lead us to be cautious. At the same time we are optimistic due to advancing technology and perpetual innovation that continually propels both our standard of living and life expectancy. Stock prices may be just a little ahead of fair value, ultimately reflecting the strong intrinsic value progress of most businesses, supported by tax reform and steady economic growth over the last two years. SEM's earnings growth relative to the market this past year and outlook for 2020 remain superior which we discuss below, resulting in no meaningful portfolio changes.

Largest Global Market Strain and the Importance of Brands

SEM's portfolio companies do business all over the world. While the health of the U.S. is paramount, growth in global markets are vitally important as well, especially China which is a top trading partner. China will likely overtake the U.S. as the largest global economy in 2020 or 2021. The "Limited" trade agreement between China and the U.S. that surfaced in the fourth quarter this year is a positive step but may not reverse what could be permanent damage from the trade tussle for many U.S. multinational companies.

The primary change in China, which has accelerated the last few years due to the strain in relations with the U.S., is the Chinese consumers' greater acceptance of local brands. Patriotic preference, improved quality of Chinese goods and ease with which brand messaging is distributed through social media, has led more U.S. brands to fall out of favor, as highlighted in a recent *Wall Street Journal* article. For example, brands like Oreo have succumbed to local brand snack maker Three Squirrels, as it extended its brand image via cartoon characters popular enough to attract hundreds of millions of viewers with an online show and $1.5 billion in annual product sales.

SEM companies with important operations in China that we believe are among an elite group of brand concepts that resonate successfully with global consumers include **Nike (NKE), Starbucks (SBUX),** and **Apple (AAPL)**. While these brands are still growing within the overall Chinese market, they face local challengers, including Li-Ning Sports Goods, Luckin Coffee, and Huawei (among others).

Nike has had great success as of late growing 23% in local currency in China. The key to its recent success in China as well as the U.S. is its direct connection to customers like never before. Online sales are NKE's fastest growing segment and were +38% in the most recent quarter. In the past, NKE's key relationship was with retailers like Foot Locker. While distributor relationships are still very important, the direct path to the consumer is the way to go. NKE has accumulated over 185 million direct connections through its Nike Plus loyalty program. Those connections can be personal and interactive, gaining insights into their customers' needs and delivering a more customized design and experience. Mark Parker, retiring CEO, recently claimed that half the population is in footwear that is the wrong size. The Nike Fit software application uses scanning technology and machine learning to accurately fit customers to each shoe in store and online.

In any marketplace, technology that improves the customer experience can drive growth. Luckin Coffee**, Starbucks'** Chinese competitor, emphasized fast delivery and set up store design to support a population "on the go." SBUX had to catch up to Luckin since it traditionally emphasized in-store consumption, and it applied many of the same improvements it has in the U.S. including digital pay and mobile order processing, especially through smartphone transactions. SBUX has 31,300 stores globally, with about 18,000 in the U.S. and the remainder internationally. The company has approximately 4,100 units in China and believes the long term market potential there is 20,000. Last quarter SBUX improved to 5% same stores sales growth driven by the U.S. and China, solid results for any global consumer company.

The mobile phone market in China drastically changed in less than a decade. In 2011 three foreign brands, Nokia, Samsung and **Apple**, dominated with 70% market share according to *The Wall Street Journal*. By early 2019, 70% of the market share shifted to Chinese manufacturers, Huawei, Oppo and Vivo. Apple has had its up and downs in China over the last decade while maintaining a generally good relationship with consumers and government officials, as overall its Greater China sales were $44 billion in 2019, meaningfully higher than the $13 billion Apple reported in 2011. In China 5G technology is ramping more quickly than in the U.S. as first tier cities such as Beijing and Shanghai should be close to full 5G network coverage. While the uptake has been a bit slow for 5G handset sales (only a few hundred thousand as of the last available report), if the prices start to come down, Chinese citizens will likely be clamoring for new phones to benefit from the higher speeds and services, such as better health monitoring. According to a Chinese report sourced by ZDNet, more than 10 million users have registered for 5G plans from local Chinese mobile carriers. AAPL will need to release a 5G phone for the Chinese market though we have not seen any release dates. It would be unusual to see AAPL's 5G phone released in China first, but likely the product lab will release both the U.S. and China at the same time, late summer to fall of 2020. Meanwhile in the U.S., AAPL's strong services and wearables business (such as AirPods) demonstrates the strength of its ecosystem and loyal users, driving tremendous free cash generation and an outlook for 8%-10% earnings growth in the coming year.

Other global brands, that SEM does not own, face tougher roads. Capital equipment companies especially large industrial equipment like Caterpillar (CAT) and Deere (DE) have seen the trade tensions impact not only demand from local Chinese customers but also U.S. customers that can't be certain they will be able to export as much farm goods to China. In the past, many western companies and perhaps a few European based firms such as Adidas, had the early growth in China all to themselves. Now they must compete to win against local companies. We believe that SEM owns some of the best global brands though we will continue to watch the competitive landscape closely. Brands, innovation and relationship building all play an important part of being successful in China, just like any other place in the world.

<u>How to Think about Annual Returns – Don't Get Emotionally Charged Up or Down!</u>

The strong market advances in 2019 followed the stock market price collapse in the fourth quarter of 2018. The last two years of returns were +35.7%/+1.2% for SEM versus the S&P 500 +31.5%/-4.4% in 2019/2018, respectively. Compare these two years to SEM's since inception annualized return of +9.5% versus the S&P 500 of +7.6% and you might correctly observe that the last two years came nowhere close to the long-term average annual returns. Taking an even closer look at SEM's annual returns compared to the market show what took place in the last two years is fairly typical- but likely unexpected or hoped for! We would like to see our returns each and every year be very close to the averages with no fluctuations, but this is not the reality. Here is where it gets interesting. If we widen the range and were to ask you, "Of the combined 44 annual periods for SEM and the S&P 500 (since our inception 22 years ago), how many periods do you believe either SEM or the S&P 500 posted a calendar year return between 5% and 10%?" Our experience is that a room full of people would raise their hands and say that at least 22 periods or more, at least half the time, would be within the long-term range. Why does it work out that way? It is human nature to desire steady returns. The reality is that only in 4 of the 44 periods did SEM or the market report a return between 5% and 10%! Said another way, over 90% of the time the annual return was either below 5% or above 10%.

Bernie Madoff made this investor craving for smooth returns the core part of his Ponzi scheme. The firm purported a steady 1% or so a month to produce annual returns better than 10% and never suffered an annual loss or meaningful volatility per the *Los Angeles Times*. He was clever enough to avoid very high returns so his clients believed him and they raved about the consistent performance; while at the same time they could not tell you what he was doing. Shrouded in mystery and low transparency (producing client statements only on his own letterhead) his fraud ran for over a decade until 2008, even when doubts were raised as far back as 1999.

At SEM (and the market) you will experience volatile annual returns, which is the inherent nature of markets. Importantly, you have transparency (your brokerage statement from a national institution accessible daily and whose value ties to any report from SEM), over 20 years of client letters explaining our process and results (and accessible on our website) and an independent firm that verifies our results (report available on request), as required by our industry standards.

Turning back towards the recent market volatility, in the fourth quarter of 2018 the market declined sharply mostly on fears of a U.S. China trade war, then sharply rose in the fourth quarter of this year when a "Limited" trade deal with China made the headlines. In particular, the last two years of stock price movements clearly show that the short run direction is influenced by an emotional reaction to events, but ultimately longer term reflects the positive direction of global economic growth and more specifically business profits over time.

Future calendar year predictions are futile. In spite of the multiple times any given morning the hosts from CNBC ask their guests, no one has an accurate crystal ball for how the stock market will perform in 2020. So what can we learn from calendar year returns? Nothing, pay no attention. Do not get overly positive when the return is high or negative when it is low.

Earnings Catch- Up

In our opening paragraphs we identified that stock prices may have gotten a little ahead of earnings (or intrinsic value) growth. Our judgement comes from over 25 years of experience and of course the data we collected and observed over this time period and beyond. Our observations regarding the price to valuation landscape at any given moment in time is not a prediction of the stock market's direction in the near term. As mentioned just above but deserves repeating, the market is driven by emotions in the short run, but importantly and fundamentally earnings (or intrinsic value) growth in the long run! Earnings growth over time will support today's stock prices and SEM's growth portfolio appears to be in a much better position than the overall market averages during this past year and outlook for next.

We measure valuation in part by free cash flow yield, the measure per share of how much cash (excess) our businesses generate for every $1 we have to pay today per share of the stock. Our portfolio today is priced at a free cash flow yield of approximately 4%. This yield is often compared to what you can get in other investment categories such as fixed income, where today the yield on a 10 year U.S. Treasury is considerably less at 1.8%. The most expensive time period our portfolio has experienced was in 1998-1999, in the height of the dot-com era that carried all stock prices higher, and our yield then was in the low 3% range. The cheapest our portfolio has been was during the market and economic decline of 2008-2009 when the economy temporarily sank and market emotions followed to extreme negatives, our free cash flow yield rose to 7%+. While we lean towards the above average valuation, for us to get back to a historical low of 3% free cash yield either (1) stock prices would have to advance another 25% and earnings would remain flat or (2) earnings would have to collapse by a similar amount while stock prices remain unchanged.

SEM's earnings results for 2019 and the growth outlook for 2020 are significantly ahead of the market, with growth this year about 10%, strong enough but slightly below our long term average of +11-13%. Two circumstances contribute to slightly lower earnings growth for our businesses this year. Corporate tax reform and a stronger economy drove 20%+ earnings growth in 2018 and coming off that historically strong year might be resulting in slightly lower growth this year. The second contributor and by far the larger cause has been increased spending by some of our largest companies, especially but not exclusive to **Facebook (FB)** and **Google (GOOG).** Both are supporting the rapid growth of their businesses and profits over the last decade, as well as the need to catch up with supporting the success and safety of their users and clients. *Importantly, SEM's earnings growth in 2019 of approximately +10% shines in comparison to the S&P 500 expectation of only +2%, and the initial outlook for 2020 has SEM's growth at +12% versus +4% for the S&P 500 according to consensus estimates in Reuters Eikon.*

The final point to cover here is how the math works. As we said above, earnings growth supports valuation and rising stock prices over time; that is why we buy and hold select businesses for the long term, in spite of short periods of time where prices may get a little bit ahead. At a 4% free cash yield, if our earnings grow 12% this year, and if stock prices are unchanged, one year from now our free cash yield would advance to 4.5%+ (our starting point yield advancing at the return on capital and growth rate of our businesses). For each year that our earnings grow, and if at the same time stock prices are temporarily flat, our portfolio gets cheaper.

If the overall economy were to go into a general decline, SEM's portfolio earnings may still grow. Since our inception 22 years ago, the SEM portfolio has never had an overall earnings decline. Our lowest earnings growth was +5% or so in 2009 versus the S&P 500 earnings decline of over 15%. For sure we had a few companies whose earnings did contract in the very tough economy of 2009. But in the aggregate we owned companies like GOOG which was growing organically and **Berkshire Hathaway (BRKb)** which was growing its intrinsic value through the purchase of assets and businesses at discounted prices. At SEM we own a select group of quality businesses that can still grow in the face of a general economic decline, albeit at a lower rate. This is a distinct difference and in our view an advantage over passive market index funds or ETFs, that own hundreds of securities, with exposure to the entire economy and will perform accordingly.

Bright Future and Bumpy Path; Stick with a Sound Investment Plan

There is always so much we are excited to cover but we try to limit the letter to a digestible amount. We live in a bright period of discovery but a bumpy path to get there. Trade scuffle implications will continue and the impact has been much deeper than just the change in Chinese consumer tastes. Supply chains for the last few years have undergone major disruption and some time spent on this subject in future letters and how our companies have managed this change would be valuable. We have a Presidential election coming in 2020 and we have also seen a huge shift towards "stakeholder capitalism" that bears some watching and comments. These two subjects tie closely to public concern and of course candidates posturing on issues including personal data privacy, jobs that may get replaced by robots and the increasing use of artificial intelligence (AI) in business and safety monitoring. Capitalism supports freedom and prosperity from hard work; when that gets altered by directives of socialism by an "all-caring" and protective government, it just doesn't work.

New technology always comes with challenges and dislocations, but throughout history it has always improved standards of living and life expectancy. Looking ahead, how many of you have heard about the field of epigenetics? An exciting field highlighted in a recent *Wall Street Journal* article in which biologists are studying and learning how to slow down or even turn back the clock at the cellular level that governs aging! The Greenland Shark can live to 500 years of age; isn't that worth studying? A certain jellyfish is made up of cells that can reverse course to become juvenile cells, essentially becoming functionally immortal. Can you imagine that aging is just a disease and life may be extended considerably through gene management? Using advanced technologies such as AI to study these species and protect them will enhance their lives and perhaps ours.

The key to investment success is to stay with a sound investment plan built for your specific family or retirement needs. Karl Marx said, "From each according to his ability, to each according to his needs." While his purpose for that statement was slightly different, your family plan should be tailored to your needs, your comfort and your ability to handle and make good decisions in a marketplace driven in the short run by emotions, fluctuations and volatility. It is textbook human nature to accelerate contributions after the market has gone up and likewise liquidate a portfolio after a market decline, believing those trends will continue. We have considerable years of experience and have witnessed these mistakes made over and over again trying to time the market's ups and downs. "Going to Cash," paying the taxes (in a non-qualified account) and guessing re-entry is not a successful strategy and we have never seen it done well on a consistent basis. The volatility of annual stock market returns should not change your long term commitment to saving and investing, nor should it impact the annual withdrawal plans if your investments are in the support mode of your well- planned retirement needs. Stick to the long term plan that should be reviewed once or twice a year, or as your goals change.

It will always be SEM's responsibility to give you a general sense where market prices are relative to the approximate intrinsic value of our businesses. We believe our process of long term ownership of select companies has been successful for our clients specifically because we have avoided the "market timing" path of some of our peers and individual investors alike. Both personally and with our colleagues at SEM, we continue to put our new savings to work investing for growth long term. Our company profit sharing plan and personal capital is invested in the same high-quality companies as our clients. We are humble enough to know we can't rest; we continue to study, learn and evolve our **SEM-DIS** (SEM-Disciplined Investment Process). We constantly monitor our existing businesses' progress, as well as their ability to keep their competitive advantages and profit growth intact. Businesses change so we will not be perfect with each and every company. But the basic tenets of SEM-DIS remain unchanged, high quality businesses with great balance sheets which continually generate excess cash. Since inception our portfolio return after fees is above the market and the vast majority of our peers, while incurring less risk than the overall market. Many thanks as always for your continued confidence. We will work hard on your behalf and best wishes to all for a peaceful and successful 2020!

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 (2019)	+35.7%	+31.5%	$ 1,356,900	$ 1,314,900
Three Year	+21.6%	+15.3%	$ 1,796,200	$ 1,531,700
Five Years	+12.6%	+11.7%	$ 1,810,500	$ 1,738,600
Seven Years	+15.3%	+14.7%	$ 2,713,400	$ 2,616,800
Ten Years	+13.7%	+13.6%	$ 3,605,900	$ 3,566,600
Inception (22 Years)	***+9.5%***	***+7.6%***	***$ 7,365,500***	***$ 5,045,800***

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