Third Quarter 2021

October 1, 2021

The U.S. mini economic boom continues but is showing some signs of interruption due to the Delta variant of the Covid virus. Some pockets of slower growth may not be enough to derail what could be one of the strongest years of earnings in the last 25 years. The equity markets reflect both the significantly higher earnings level and anemic competition from fixed income with very low interest rates.

As we enter the cooler months for many parts of the U.S., we will likely experience some bumps along the way. We will need to digest the forthcoming presidential tax policy changes at both the corporate and individual levels. Supply chain issues persist and include materials, semiconductor chips, as well as labor, with global Covid case spikes disrupting factory work schedules. The inability to meet demand due to supply chain issues is hitting some of our companies' operations and earnings, especially **Nike (NKE)**, which resides in our **SEM Select Growth** and **SEM Dividend Growth** portfolios.

The markets are forward looking, so as we turn towards 2022 the focus will be on what will next year's earnings growth be factoring in supply chain constraints and Covid. Will we see a return to more normal growth levels following the economic boom, as corporate capacity constraint issues ease mid to late next year? We hope Covid will have finally peaked globally for both humanitarian and economic reasons. No matter the current environment, it is always useful to revisit the principles that got us successfully from our beginnings to the present, as we prepare for the future.

SEM recites the Three Guiding Lights

Just as you might repeatedly study the wisdom bestowed in a respective religious scripture, we like to revisit the three guiding lights of investing, as taught to us by our forefathers. Like any guiding principles they seem obvious and thoughtful but may not be practiced by many in daily living.

1) *Invest in Businesses, not Stocks* – When you invest in *businesses*, be it 100 shares of Home Depot or becoming part of owner of a local Hampton Inn, your approach should be the same. You conduct business analysis including determining your return on capital, review the balance sheet and cash flow of the businesses. If you buy a *stock*, much like we have seen with the "meme" stocks of the past year such as **Gamestop,** you are just hoping or speculating about the stock price direction.

2) *Margin of Safety* (MOS)– we can write a book about this important principle. Though traditionally defined as the gap between price paid versus intrinsic value, which we connect with, we view MOS from a larger perspective. MOS is about seeking every opportunity to reduce the chance of a permanent loss of capital. The greater the MOS, the lower the chance of loss. The **SEM-Disciplined Investment System (SEM-DIS)**, which permeates all three of our equity portfolios, seeks a high level of MOS through multiple components that include but are not limited to a) only investing in a business you understand, which is why we avoid certain businesses and b) employing a disciplined process that focuses only on businesses with exceptional financial health – including those that earn a high return on capital, while utilizing little to no debt, and generate excess cash flow. Businesses with a consistent history of strong economics also have a higher probability, though not a guarantee, of continuing in that mode.

3) *Approach to the Stock Market* – Simply put the market is there to serve us if we are looking to purchase a part interest in a business or to sell all or part of an interest that we own. SEM's job as a team, with experience dating back 30 years and beyond, is to assess the intrinsic value of the business, independent of what the stock market price is for the company.

From our years of experience, this mindset gives us an enormous advantage and these guiding lights embedded in our **SEM-DIS** helped us produce results above the market averages while taking less risk. We also believe that our mere avoidance of certain businesses with subpar economics or inconsistent operating results has added to our relatively good long-term results. We believe reducing risk is a key characteristic of achieving good results; and at the same time, risk is not the short-term volatility of stock prices but rather risk is paying more than a business is worth. The longer you own a part interest in a publicly traded business, the better probability the stock price reflects the economic progress or lack thereof of the business.

Mini Economic Boom

As we turn towards the homestretch in 2021, the outlook for SEM's three growth portfolios and the general market is to experience earnings growth of 20%+. What demand the pandemic took away in 2020 has come roaring back in 2021. We talked about acceleration in digital technology as an important contributor in our previous letters. Yet likely the most significant source of consumer spending in 2021 was the large amount of personal savings and individual taxpayer income relief from the government accumulated in 2020. Consumer demand has been so strong from pent up savings that it's hard to find discounts in everything ranging from clothing to cars! The lack of discounts has lifted operating margins and profits for most businesses.

Is SEM Emotionally Lacking? We hope that's true!

Legendary New York Yankee catcher Yogi Berra once said, "It's tough to make predictions, especially about the future." We wholeheartedly agree; so, at SEM we observe, we don't predict. We continue to observe Covid- 19 and its respective variants, and we can prepare ourselves that it can be disruptive to growth and can continue to bring volatility to the markets in the short-run, as we have already learned. We know Covid-19 will eventually peak globally in cases and severity, and as many expect, we believe Covid-19 will become endemic. We continue to watch supply chain constraints but can only forecast that they will eventually subside, we just don't know when.

We can't predict, as many are trying to do, what the economy will be like when the supply chain issues are no more, and Covid-19 is endemic. We don't know if demand will soar, return to more normal levels or decline. And we don't know what other headwinds or tailwinds will surface.

It may seem as though these comments lead to the conclusion that we are emotionally lacking. We would say that is the correct assessment. We are emotionally lacking because that is precisely the characteristic that it takes to make good investment decisions during markets when emotions run from deep depression to exceeding optimism! As a matter of fact, a very smart and terrific new client that has a passion for investing passed along an article about "How the World's Greatest Investors Think." The article, published by the American Association of Individual Investors, highlighted this very point, among other observations.

Our client commented that it seemed we had similar attributes to some of the great investors in the article. While we are honored by his comments, we are humble enough to know we need to keep working hard at what we do. We understand we will make mistakes but the **SEM-DIS** is built to minimize their impact. Importantly, we never stop learning and continuing to improve the **SEM-DIS.**

We choose to be optimists, as that puts us in a better frame of mind, especially since we are long term investors. At the same time, we always respect the existing global challenges at various levels, and yet are steadfast in our belief that current generations will press forward to provide a better standard of living for future generations.

Our goals are to continue to preserve and grow your capital in a prudent manner. We are grateful for the journey with you as our client. We wish you a safe and enjoyable holiday season!

Sincerely,

Don	*Dan*	*Amy*
Donald R. Jowdy	Daniel T. McNichol	Amy A. Lord, CFA
CIO	President	SVP / Co-Portfolio Manager

The views expressed herein are strictly the opinions of Suncoast Equity Management LLC and we make no representations as to their accuracy. This piece is intended for informational purposes only and is not a solicitation to invest money or buy or sell certain securities.

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Through the third quarter of 2021, **SEM's Select Growth** is +16.9% slightly ahead of the S&P 500 market index of +15.9%. Earnings growth in 2021 may be close to record high for SEM as well as the S&P 500. We talk about a mini economic boom, supply chain constraints and Covid-19 that could impact earnings as we head into the fourth quarter and into next year in our ***SEM Investment Management Commentary***. For **SEM Select Growth**, we cover how pricing power differs between our portfolio holdings and companies that are "price-takers." We discuss our portfolio change with **VMware** and highlight a similar but more successful holding of Adobe. Acquisitions can destroy or add value to shareholder returns, and we share our thoughts on Intuit's largest proposed acquisition.

Pricing Power that Sticks

Last quarter we briefly discussed inflationary trends but noted that innovative companies and those with pricing power can offset higher input costs. This quarter we'd like to highlight two of our asset-light businesses that have pricing power which not only offsets their costs but also increases margins over time. In August **PayPal (PYPL**) increased merchant fees from 2.9% +$0.30 per transaction to a fixed rate of 3.49% +$0.49, which is a 20%+ increase. With more than 50% market share in the U.S. payment processing market, PYPL believes merchants will pay more for their value-added services than risk changing platforms at the expense of productivity and customer preference. Similarly, **Microsoft (MSFT)** will raise prices 10% or more for Microsoft 365 effective March 1st, 2022 (formerly known as Office 365 with apps like Word, Excel, and Teams). The price increase is supported by MSFT adding new features and significant functionality to the application suite. With 300 million commercial Office 365 paid seats, most of the new subscription pricing will increase 15-25% but individual consumer and education subscriptions won't be impacted.

SEM-Disciplined Investment System (SEM-DIS) focuses on businesses with pricing power that can last throughout the entire business cycle, as compared to commodity type businesses that we classify as "price takers" and whose condition can weaken considerably when pricing and economic conditions falter. For example, lumber prices hit an all-time high of $1600 in early May and fell to $400 in September, a *75% decline* in 4 months.

So, although lumber producers benefited temporally from increased demand and limited supply that led to prices soaring 400%+, they have no control over the price of their main product. Similarly, airfare pricing started to pick up earlier this year as domestic travel returned but is now 15% or so below its summer highs as well as pre-pandemic levels. A recent *Wall Street Journal* article highlighted that average domestic airfares ticked down about 10% to $260 from $284 in 1996, though baggage fees offset that decline. As long-term investors we prefer to be part owners of businesses with "sticky" prices which ultimately help generate consistently higher operating margins.

<u>Portfolio Activity and Highlights</u>

After four years of ownership, we sold our remaining small position in **VMware (VMW)**. During its second quarter earnings announcement management acknowledged the transition from a licensing business model to a subscription business model will likely take longer than expected. We have witnessed this before. **Checkpoint Software (CHKP)** is a recent example which we sold last year. Although it generates lots of free cash flow, it has struggled to grow revenues and profits.

The transition to the subscription model, when well executed, can greatly improve the economics of the business. One tremendous success story is **Adobe (ADBE)**. Prior to our purchase in 2017, ADBE struggled to grow its cash flow and earnings from 2013-2015 as it made a similar transition in its business model. It took until 2016 to surpass its previous highs in terms of revenues and operating margins, which was one of the main drivers that led to our purchase. Ultimately ADBE succeeded and continues to do well, as it adds new products and features to its subscription offerings through both organic and bolt-on acquisitions for one of the most comprehensive offerings used in print, digital and video content creation.

<u>Capital Allocation and Acquisitions</u>

Business growth can be organic as well as through acquisitions. With a portfolio of businesses that accumulate free cash flow on their balance sheets, we pay attention to how they spend it. Excess cash on the balance sheet is a lot like giving your kid money to shop for candy or a toy, no doubt it will be spent it is just whether it is done wisely. **Intuit (INTU)** announced an agreement for its largest purchase ever of **Mailchimp** for $12 billion in cash plus stock and plans to issue $4.5-$5.0 billion in new debt to help finance it. We are reasonably certain the closely held sellers would like to close in 2021 due to proposed tax law changes.

Although it may be a little bit of a stretch for INTU, as it has $1.8 billion cash (net of debt) and the forecast for free cash flow next fiscal year ending July 2022 is about $2.5 billion net of dividends, strategically it appears to be a good fit. INTU's bread and butter is the small to midmarket businesses which are the same customer base at Mailchimp. Mailchimp, which offers e-Commerce, marketing automation, and customer relationship management (CRM), will add to INTU's small business suite of services including *QuickBooks* accounting and payroll. In a survey that Intuit ran it found nearly 80% of small and midmarket businesses don't have a formal CRM system so combining financial accounting with CRM in one provider may prove very valuable. As always, we will be watching closely to see how it develops.

Looking Ahead

We are excited about the digital acceleration in consumer markets and the benefits it bestows on our portfolio of companies. We continue to monitor earnings growth and valuations considering the potential impact of uncontrollable events, including Covid-19.

Thank you for your ongoing support and please contact us anytime as we welcome discussion.

Sincerely,

Don	*Amy*
Donald R. Jowdy	Amy Lord, CFA
CIO	Senior Vice President/ Co-Portfolio Manager

Suncoast Equity Management, LLC

Performance results versus the Standard & Poor's 500 Index

Time Period	**SEM % Return***	**S&P 500 % Return**	**SEM - Growth of $1,000,000**	**S&P 500 – Growth of $1,000,000**
First Nine-Months (2021)	+16.9%	+15.9%	$ 1,168,600	$ 1,159,200
One-Year	+27.4%	+30.0%	$ 1,273,600	$ 1,300,000
Three-Year	+20.7%	+16.0%	$ 1,758,700	$ 1,560,700
Five-Years	+21.5%	+16.9%	$ 2,643,000	$ 2,182,600
Seven-Years	+15.7%	+14.0%	$ 2,779,600	$ 2,504,000
Ten-Years	+18.0%	+16.6%	$ 5,228,000	$ 4,658,600
Inception (23 3/4 Years)	***+10.6%***	***+8.5%***	***$ 10,908,200***	***$ 6,925,400***

* Composite results of all SEM Select Growth 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

Performance Disclosure

Suncoast Equity Management, LLC (SEM) is an independent investment management firm established in 1997. Suncoast Equity Management is primarily an equity investment manager that invests in U.S.-based securities. SEM also invests in high-grade fixed income. The Suncoast Equity Management Composite includes all discretionary, fee-paying portfolios managed within this strategy. The equity composite was created on 12/31/1997.

Bundled fees include management consultant fees, custodial, trading, and advisor fees. Performance is calculated gross of all foreign withholding taxes. Additional information regarding policies for valuing portfolios, calculating performance, and preparing compliant presentations, as well as a complete list and description of composites, is available upon request.

For the non-bundle fee accounts, the performance results presented are net of actual investment advisory fee and net of all transaction costs. For the bundle fee accounts, the performance results presented are net of actual investment advisory fee and net of all transaction costs and expenses. Investment advisory fees are described in Part II of Suncoast Equity Management, LLC's Form ADV. The management fee schedule is as follows: 1.00% fee on assets managed. The Firm does not assess performance-based fees.

It is impossible to invest directly in an index. The performance of an index does not reflect any transaction costs, management fees, or taxes. The index used for comparison is the Standard and Poor's 500 Total Return. It is an unmanaged index with no expenses, which covers 500 industrial, utility, transportation, and financial companies in the U.S. markets. It is a capitalization-weighted index calculated on a total return basis with dividends reinvested.

Valuations and returns are computed and stated in U.S. Dollars. The Firm does not use leverage or derivatives to implement the intended strategies.

Beginning in June 2002, accounts that experience cash flows in excess of 10% of the account's market value are temporarily removed from the composite. These accounts are added back to the composite when they are considered fully invested. The minimum account value for inclusion in the composite is $100,000. Additional information regarding the treatment of significant cash flows is available upon request.

Past performance does not guarantee future results. Investment returns and principal value will fluctuate. Investments may be worth more or less than their original cost when sold. It should not be assumed that investment decisions we make in the future will be profitable. Current performance may be lower or higher than the performance data shown. Returns include the reinvestment of all income.

Suncoast Equity Management claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Suncoast Equity Management has been independently verified for the periods 12/31/97-12/31/19. Verification assesses whether: (1) the Firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The SEM Equity composite has been examined for the period of 12/31/97 to 12/31/19. The verification and performance examination reports are available upon request. Suncoast Equity Management adheres to the GIPS valuation hierarchy Principles. For any additional information, please contact the Chief Compliance Officer at (813) 963-0502.

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