July 7, 2014

Dear Friends of Coho Partners:

June was the fifth consecutive month of positive returns for both Coho Partners and the benchmarks, but unfortunately we lagged for both the month and the quarter so that we are now trailing on a year to date basis as well. We never enjoy underperforming, but we remain encouraged by our holdings, their outlooks and most importantly, their risk/return profile.

All sectors had positive returns this quarter, with Energy posting a double digit gain which easily made it the best performing sector. Financials were the worst sector, but were still up 2.2% for the quarter. Essentially all of our underperformance this quarter came from stock selection, with our limited Technology holdings being the largest drag. IBM was the culprit this quarter, but here too, we believe the long term prospects are quite good even as we recognize the near term outlook as somewhat challenged.

We are long term investors focused on understanding the truly long term operating and financial strategies of our companies to see if they have the resources (balance sheet) and talent (management) to achieve their goals. As we have said in the past, the path to wealth creation is not a sprint but a marathon and there will always be detours along the way. So we thought it might be illustrative to share with you our thought process on one of our most recent purchases, PetSmart, which was our worst performing stock this quarter. For those who might not know the company, PetSmart is a leading competitor in the pet retailing space, selling both pet foods and pet supplies, as well as offering boarding, training and other services. The pet care market is estimated to be about $37 B and it grows about 4% to 5% annually. We commented on this company briefly in our May letter, but hopefully this elaboration will be more revealing.

We initiated our position in March of this year when the stock traded down in sympathy with other retailers who were being negatively impacted by the competitive threat posed by Amazon. We concluded that the pet food/supply market and PetSmart's ancillary services were significantly less likely to be disintermediated by Amazon. Amazon is a great competitor, but it does not provide currently offered PetSmart services, such as boarding, grooming or training, which drive traffic and other purchases in their stores. Thus, the initial sell off in March created a good buying opportunity, which was confirmed by our dividend discount model. When the company reported its first quarter results in May, we were disappointed but not surprised by the slowdown in comparable store sales. The stock sold off dramatically on this news and we decided our thesis was still very much in force so we added to our position in late May. We continue to believe the soft comparable store sales and transaction trends were more a function of the lackluster macroeconomic environment and the horrible weather in many of PetSmart's markets. These issues will normalize over time resulting in a reversal of the downward trajectory in transactions and comparable store sales. Prior to adding to our initial purchase, we spoke with Carrie Teffner, Chief Financial Officer of the company, and concluded that the competitive environment remains tough but it was not getting worse. Equally important, issues resulting from the execution of the first quarter reset of its consumables segment (food and treats) were very correctable. Specifically, PetSmart added 900 new stock keeping units (SKUs) and removed 750 other SKUs. Such a major restructuring altered the look and feel of their stores and may have temporarily disrupted the shopping experience. Financially, the company has lots of flexibility since it has $230 M in cash and no long term debt. PetSmart should be able to grow at least in line with the overall pet supply market and they should continue to generate significant free cash flow. Their current policy is to use roughly 80% of this free cash flow to repurchase treasury shares and the remaining 20% for dividends. We expect earnings per share growth in the high-single to low-double digit range with double digit annual dividend growth.

Just last week we learned that an activist investor has amassed a 9.9% position and will likely push for even more shareholder friendly cash returns. This news was greeted warmly by investors and our position is now solidly profitable. However, the real take away here is not that we are now ahead on this investment, but rather the process that we undertook to get to the position we have today. PetSmart is a very well-run, scale player in a steadily growing and reasonably recession resistant industry. The confusion in the Consumer sector surrounding the long term impact of online retailing has allowed us the opportunity to invest in this company at very attractive prices. We clearly believe we have invested in a wonderful company with many positive attributes and hopefully our success will occur many years from now at significantly higher prices than today. In the meantime, our job is to constantly monitor those opportunities for all of our companies. Our Coho 250 universe is packed with what we consider to be superb companies with growing, recession resistant business models. Our challenge is to find those priced at a discount to their long term valuation. As we often say at Coho Partners, there are many wonderful companies, but there are few wonderful companies selling at significant discounts to fair value.

So as we enter the last half of 2014, we are sorry for trailing the benchmarks thus far, but our companies are executing the way we like. Roughly 85% of the portfolio's holdings have increased their dividend this year with United Health's June increase of a better than expected 34% being the latest. Additionally, the vast majority of our holdings will reduce their outstanding share count. We believe these two financial actions build in downside protection. Because we begin with a very competitive dividend yield that currently matches the ten year US Treasury and by reducing the share base consistently over time (without leveraging the balance sheet unnecessarily), means that our ownership position grows incrementally each year. So, as long term shareholders, we would be happy to ultimately own a continually growing stake, assuming the company continues to execute vs plan.

As always, please do not hesitate to call us with questions or concerns about our outlook or your portfolio.

Peter A. Thompson

Brian L. Kramp, CFA