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Transcript of RCI Hospitality Holdings, Inc.
Fiscal 2016 Fourth Quarter and Year-End Conference Call and Webcast
December 13, 2016

Participants

Eric Langan – President and Chief Executive Officer
Phil Marshall – Chief Financial Officer
Gary Fishman – Investor Relations

Analysts

Frank Camma – Sidoti & Company
Mike Mork – Mork Capital Management
Jeffrey Benton – Fairfield Advisors
Bill Brown – Private Investor
Evan Tindell – Bireme Capital

Presentation

Operator
Greetings, and welcome to the RCI Hospitality Holdings Fiscal 2016 Fourth Quarter and Year-End Conference Call and Webcast. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. As a reminder, this conference is being recorded. It is now my pleasure to introduce Gary Fishman, who handles Investor Relations for RCI. Please begin.

Gary Fishman – Investor Relations
Thank you, Tim. Please, everybody, let's start by turning to slide 2. Thank you. I want to remind everybody of our Safe Harbor statement posted at the beginning of our conference call presentation. It reminds you that you may hear or see forward-looking statements that involve a number of risks and uncertainties. I urge you to read it. Actual results may differ materially from those currently anticipated. We disclaim any obligation to update information disclosed in this call as a result of developments which occur afterwards.

Please turn to slide 3. I also direct you to the explanation of non-GAAP measurements that we use and that are included in our presentation and news release.

Finally, I'd like to invite everyone in the New York City area to join us at Rick's Cabaret New York tonight at 6:00, to meet management, at Manhattan's number one gentlemen's club, and then to tour our new sister club, Hoops Cabaret & Sports Bar next door. Rick's Cabaret New York is at 50 West 33rd Street. That's between 5th Avenue and Broadway, around the corner from the Empire State Building. If you haven't RSVP'd, ask for me at the door.

Now, I'm pleased to introduce Eric Langan, President and CEO of RCI Hospitality.

Eric Langan – President and Chief Executive Officer
Thank you and thanks for joining us today. Good afternoon, everyone. Please turn to slide 4. After the market closed, we announced fourth quarter and year-end results. On a GAAP basis for the quarter, we earned $0.04 per share. For the year, we earned $1.10 compared to $0.90 last year. Keep in mind that these results include a

number of fourth quarter net charges, most of which are related to the expansion of our capital allocation strategy as we had announced in October.

Adjusting our results for these and other items, on a non-GAAP basis, we experienced a strong fourth quarter performance. EPS came in at $0.31 per share, approximately 47% higher than the $0.21 we did last year. For the year, we earned $1.32 per share compared to $1.35 last year. This reflects lower comparisons in the first half of fiscal year 2016 and a rebound in the second half.

Even more important, we exceeded our initial free cash flow target going into the year, generating $3.8 million in the fourth quarter and $20.5 million for the year. As a result of the first full year implementation of our capital allocation strategy, we ended fiscal 2016 in great shape. We are on track for improved revenues, margins, and profits in fiscal 2017 as well as baseline free cash flow run rate of $18 million. In addition, we continue to apply our capital allocation strategy as evidenced by our ongoing share buybacks in the first quarter of fiscal 2017.

If you'll please turn to slide 5. Our focus at RCI is growing free cash flow per share. Thus, our capital allocation is critical. For those of you new to RCI, I'd like to take a minute to review the capital allocation strategy we put in place a year ago. We've updated this slide for our lower share count due to buybacks and the pay down of convertible debt.

We have two major uses of our free cash flow, one is buying back shares. For example, at $14 where the stock price has traded recently, buying back shares generates an after-tax yield on free cash flow of 13%. We consider this yield risk-free since we are buying our own assets which we know very well.

Two is buying or opening new units. We target a two times hurdle rate to account for the risk of making a new investment, absent any otherwise strategic rationale. For example, at $14 per share, we would want a new unit to produce or return about 26% or greater, which translates into a cash-on-cash return in a little less than four years. Conversely, if a unit is not performing in line with our strategy and efforts to improve it have not been successful, we will take action to free up as much capital as possible for more profitable use as we announced in October.

With regards to paying down debt, only at a much higher stock price does it make sense on a tax-adjusted basis to pay down our most expensive debt at an accelerated rate assuming no prepayment penalty. Having said that, we are always looking for ways to refinance our higher interest debt at better rates, as we did in August.

Please turn to slide 6. Our capital allocation strategy enabled us to achieve five major accomplishments in fiscal 2016. First, we improved overall performance, but most importantly, our cash generating power. This enabled us to implement the largest stock buyback in the company's history. It also enabled us to strengthen our balance sheet. To enhance cash generation going forward, we began to more aggressively manage our club and restaurant portfolio. And five, we made some selective investments that we believe will expand free cash flow in the future.

Please turn to slide 7. We restored total sales and same-store sales growth. Some of you may recall, sales softened in the second half of fiscal 2015. As you can see from these charts, over the course of fiscal 2016, we restored both total sales and same-store sales growth, going into positive territory in the second half. Looking at our major revenue lines, they generally improved over the course of the year. For example, in the fourth quarter, our higher margin service and beverage sales increased 1.4% and 0.7% over the same period a year ago. This was the fourth quarter in a row where beverage sales were up year-over-year, and it was the first quarter in fiscal 2016 where service revenue was increased year-over-year after steadily narrowing declines the prior three quarters. We expect these up-trends to continue in fiscal 2017.

If you'll please turn to slide 8. We reduced costs and expanded margins. One of the keys was using bank financing to own more of the real estate underlying our clubs. This enabled us to significantly reduce our cost of occupancy, which is a combination of rent and interest we pay. This is one of our largest fixed costs. Here you can see how it has fallen from a high of 11.2% of revenues in the third quarter of 2014 to 8.5% in the fourth quarter of 2016. As a percent of revenue, occupancy costs should continue to decline due to revenue growth, refinancings, which should help reduce average interest paid on debt, and principal pay downs. As a result of this and other efforts, as you can see our non-GAAP margin improved over the course of fiscal 2016.

If you'll please turn to slide 9. You can see this core improvement at work in the results of our two main segments. Looking at nightclubs, while sales were relatively level, non-GAAP operating margin in the fourth quarter increased to 30.2% from 22.5% in the year ago quarter. For the year, operating margins increased to 32.3% from 31.3%. This reflects our more profitable portfolio of clubs compared to a year ago but also the rising trend this year in the higher margin service revenues. And looking at Bombshells, while sales were up 6% for the year, they increased 10.5% in the fourth quarter. This reflects the tougher comparisons we had earlier this year and improvements over the course of the year.

Non-GAAP operating margin was 11% in the fourth quarter compared to 14.9% in the year ago quarter. Even though it was non-GAAP, it still includes operating losses from Webster which was closed at the end of the period. A better picture is looking at operating margin for the year. It increased to 14.3% from 12%. This reflects greater operating leverage and an increased proportion of beverage sales.

Please turn to slide 10. As a result of our overall improved performance, we increased our cash generating ability. Fourth quarter adjusted EBITDA increased 25.7% year-over-year to $8.2 million. For the year, it increased 1.2% to $34.5 million. Fourth quarter free cash flow was $3.8 million compared to a negative $2.1 million in the year ago quarter. For the year, it came in at the high end of our most recent $19 million to $21 million target range. Please keep in mind fiscal 2016 free cash flow includes about $2 million in one-time tax benefits. Taking this into consideration, we believe we've established a new higher baseline free cash flow run rate of $18 million compared to $15 million in fiscal 2015. As for cash, we ended the year with $11.3 million, the highest amount at September 30th in the last five years.

If you'll please turn to slide 11. Our free cash flow generation enabled us to implement the largest share buyback in RCI's history. As a result, we reduced shares outstanding by 5% to 9.8 million and it enabled us to pay off $2.8 million in convertible debt in fiscal 2016 and the first quarter of 2017 thus eliminating 230,000 possible new shares and 49,000 related warrants expired. Other than 40,000 potentially dilutive shares tied to a seller financed note, we have no other auctions or warrants outstanding. It has also enabled us to initiate a $0.12 per share annual cash dividend paying $0.03 quarterly.

We have continued to buy back shares in fiscal 2017. In the first two months of the year we bought back 68,269 shares at an average of $11.98 per share reducing total shares outstanding to 9.74 million. We are committed to buying back shares. As of November 30th, we have $3.4 million in remaining share purchases authorization.

Please turn to slide 12. Through debt pay downs and refinancing, we have further strengthened our balance sheet. As of September 30th, our average weighted interest rate is down to 7.23%. $77.5 million of debt or 73% is secured by real estate and all other categories of debt declined.

Please turn to slide 13. We have updated our debt maturity schedule. On the October call, we reported how we refinanced $14.2 million of debt at lower rates. We changed all 2017 non-realty balloons into an amortizing note that now balloons in 2022. And now, all of our debt is amortizing. As a result, as we pay down debt, our related interest expense should fall on a fairly steady basis. We anticipate refinancing the remaining 2018 balloons in 2017.

Please turn to slide 14. To enhance cash generation going forward, we have implemented new higher yielding financial models for new clubs and restaurants. We developed two brands that attract millennials and generate higher margins. During the third quarter, we opened our first Foxy's Cabaret in Austin, a combination nightclub and strip club for college on up. During the fourth quarter, we opened our first Hoops in Manhattan, a combination sports bar and strip club.

We started opening new units with lower cash outlays, and thus, higher potential returns. For example, through our access of banks, we are financing the purchase of land and construction to create two new Bombshells for significantly less cash than in the past. This will reduce our outlay to only $1 million per unit compared to prior models of about $3 million. And we will own the property instead of leasing.

We began to sell or close underperforming units faster to enhance our cash generation going forward and free up capital for more profitable uses. In October, we announced the sale of two nightclubs, the majority of our interest in Robust, the closing of the Bombshells in Webster, and the settlement of the most serious lawsuit cases remaining from the indemnity insurance period.

Subsequently, we've decided to impair two other properties. As previously announced, we received more than $8 million in cash and interest paying notes receivable from these sales. The fourth quarter income statements also include net charges of $5.2 million pre-tax, most of which were non-cash. Disposing of these businesses should reduce operating losses and in some situations turn non-performing operations into interest-generating assets.

Please turn to slide 15. Our fifth major accomplishment in fiscal 2016 was a series of selective investments to enhance our prospects for future growth. First was the construction and moving into our new corporate offices. We desperately needed new space for efficient personnel management and warehousing. We moved in mid-October and are already seeing the beneficial effects.

The second is implementing our new ERP system. This starts phasing in on January 1st. The key benefit is that it will connect our clubs and restaurant POS systems as well as outside banks directly into our accounting system, thus automating many of the current manual accounting processes. This is expected to greatly enhance our efficiency, data analysis, and make it much easier to put in place a scalable plug-and-play platform for adding new clubs and restaurants.

Third was recruiting Shannon Glaser to run our Bombshells franchising. Shannon put Twin Peaks on the map, literally selling 120 franchises, opening 50 of them while she was there. She has already begun setting up meetings for us with multi-unit restaurant franchise operators.

Please turn to slide 16. You can see why we are excited about fiscal 2017. We believe all the actions we've taken will help strengthen our prospects for revenue, margin and earnings growth, but most importantly, achieve our initial baseline target of approximately $18 million in free cash flow. Key factors will be the addition of Hoops in the first quarter, Foxy's Dallas in the second quarter, and three new Bombshells sometime during the second half.

A strong sports lineup has also helped. We've had the return of the Vikings in Minnesota. In the second quarter the Super Bowl will be in Houston where we have five locations, both clubs and Bombshells. Mixed martial arts events are now being held at New York's Madison Square Garden where we have three clubs nearby.

And finally, expanded margins from the disposal and sale of non-performing businesses.

On a final note, if you haven't already heard, Sidoti & Company, one of the leading brokerage firms in small caps, issued an initial report on December 1st. We plan to present at their conference in New York City this March. Also, on December 1st, the American Association of Individual Investors added us to their model shadow stock portfolio. The Association is the largest non-profit devoted to teaching people how to invest with 171,000 members in some 50 chapters nationwide.

We had a great set of meetings this year at LD Micro's investor conference in Los Angeles. People really like our story and our capital allocation strategy.

We know there is still more work to do and we are dedicated to making this happen. Speaking on behalf of RCI's management and that of our subsidiaries, I would like to thank our loyal shareholders for their support.

With that, let's open the line for questions. Operator?

Operator
Thank you. We will now be conducting a question and answer session. [Operator instructions]. One moment please, while we poll for questions.

Our first question comes from the line of Frank Camma of Sidoti & Company. Please proceed with your question, Frank.

Q: Good afternoon, guys, and congratulations on everything you've achieved so far. A couple questions here. Let's start with Bombshells. You said three slated for second half fiscal 2017. I know a couple of those are well on their way. Can you just get a little more granular of the timing of the opening of those if you can?

Eric Langan – President and Chief Executive Officer
Sure. Currently we're hoping for April, June and August. We started construction on the one that's supposed to open in April. So, provided weather doesn't cause us too much delay, April should be a fairly reasonable assumption.

With the June opening, we go to the city with the initial set of plans hopefully by December 19th. So then it's just a matter of how quickly they review, we answer their questions, get it back in and get the final permits approved. And then once the permits are approved, securing the bank financing for the construction. All that should come within our timeframe for June.

And then the third location, which will open on the east side of Houston, is in the preliminary drawing plans right now. We're prototyping the Pearland location, the June location is going to be our prototype store. So we're using a very similar deal, but because it's a different city, there are some minor adjustments to the plans that are in the process of being made. Hopefully in January we will submit those plans to the city of Houston for review and get that on track.

Q: Great. And, hopefully with Shannon obviously just getting up to speed here, you have all the licensing in place that you can do franchising in all 50 states. Is that correct?

Eric Langan – President and Chief Executive Officer
Affirmative, yes. We are licensed in all 50 states.

Q: So it's a matter of timing and obviously it takes time to sign agreements and everything. Is there a frame that you have—I'm sure you have in your head—of how long it takes from when you start soliciting, or that might not be the right term, but when you start talking to potential franchisers and when you actually open the restaurant?

Eric Langan – President and Chief Executive Officer
We have several meetings set up in January. We've actually met with an operator in December already. Because of the holidays, we've had to push a few. Everybody's schedule has been crazy so we've moved everything to January.

It really varies once we start negotiations. I would estimate a two to three-month time period and then time for the lawyers to get everything drawn up. I'm hoping that maybe in the next quarter or the following quarter we might be able to come up with our first agreement, so sometime in the next three to six months.

Q: Great, and can you tell us a little about the go-forward tax rate since obviously you had some charges here? But going forward, should we expect you to be a full taxpayer and therefore, potentially benefit from any reduction in the US federal reduction in taxes?

Eric Langan – President and Chief Executive Officer
Yes, Phil, we go back to the 35% or 36% this year. Is that your estimate?

Phil Marshall – Chief Financial Officer
I think the answer is that we will have some tax credits that we didn't use to have, but we're going to have some New York City taxes that we didn't use to have. So, they'll probably offset each other and we'll still be at 34%, 35%.

Q: Great. And one more, then I'll hop off. As far as occupancy costs, you obviously made a lot of improvements there. What can that get you over time as you scale up? Are you kind of—

Eric Langan – President and Chief Executive Officer
Well, if we pay off all of our debt, it'd be about 3%. I think we're going to see it—

Q: Sort of modify.

Eric Langan – President and Chief Executive Officer
There's not a lot of room, I don't think at this point for reduction. We do have the $9.9 million at 12%, that's now amortizing. So that will start going down a little quicker. As we pay off some of this higher interest debt, you're going to see our overall weighted rate come down which will bring down the occupancy costs.

Q: Great, thanks, guys.

Operator

Our next question comes from the line of Mike Mork of Mork Capital Management. Please proceed with your question.

Q: Hi, I have two questions. One, opening of the Hoops and Foxy's Cabaret, your stock is at $15. That would mean that you would have to get a 25% return on that. How accurate have you been, say, when you open a unit and what the return is?

Eric Langan – President and Chief Executive Officer
Well, Foxy's was a unit that we had purchased that we had not met the returns on that we converted. And now we're doing very well with it. Hoops is really still too new. We opened I think the last day of September. We really only have October and November's numbers here. The next quarter I could probably give you an idea through the first quarter. I know that our gross revenues are ahead of what we thought they would be. But I don't know where our costs are at the same time. We're still waiting as we move through this quarter. When we get November numbers, I'll have a little better idea. But, we have pre-opening costs in October and then we did a big promotion for the first UFC deal here, too. So I have to see how that equated, what our return was on the investment we made on that as well.

Like I said, I do know the gross revenues at Hoops are above what we anticipated, though.

Q: Okay that sounds good. And then the unemployment rate overall in the country is low. In the past, when the oil prices collapsed some of your six-pack, Joe six-pack guys got hurt there, working on the oil rigs and whatnot. Has that stabilized now with the oil prices coming back up? Are they coming back in the units?

Eric Langan – President and Chief Executive Officer
We are seeing Odessa and Longview, which are basically the only two markets that we were really affected by oil at, a little rebound in there. We bottomed out and now we're seeing a slow increase in the revenues in those markets. But, I think we're still a far cry from where we are. I think, from what I hear from the people out there, a $60 to $70 oil price will put those markets back in full swing now. So, that's what we're watching for to see what happens with this OPEC cut and whatnot, we'll see where oil prices head here.

If we see oil prices up, then I think those two markets come back. But you have to remember, those are a very small portion of our revenues. I think they were 3.8% of revenues at their peak, so they're even less than that now.

Q: Good, sounds good. Thank you.

Operator
[Operator instructions]. Our next question comes from the line of Jeffrey Benton of Fairfield Advisors. Please proceed with your question.

Q: Hi, Eric, congratulations on another great quarter. My question is political. Republicans from the top down to local elections seemed to have done really well. That's a double-edged sword, isn't it? They're probably going to be a lot friendlier to business but perhaps a little bit more prudish. How do you see this all playing out?

Eric Langan – President and Chief Executive Officer
I think the nice thing is, I mean, yes there are some Supreme Court issues but there's not really a lot of cases in front of the Supreme Court right now affecting zoning and operations. I'm not too overly worried there.

What we were more worried about and what we're very excited about is the Secretary of Labor, definitely a good benefit for restaurants. And some of the other appointees I think are very strong, very positive for us. And of course, as a 35% taxpayer, we were just discussing, if I get a 15% or 20% rate I'm going to be a lot happier with that. I think that the pros are going to outweigh the cons. Obamacare costs were significant when we had to initiate that. And of course, for all our executive employees that we provide full insurance coverages for, our costs are skyrocketing.

So, it'll be interesting to see how all that plays out. But, I think overall the election is turning out to be very, very positive for us so far. We'll have to see, the first 100 days are going to be very important for the whole country.

Q: That's great. Thank you. Just one other question is have you seen any penalty at Rick's from having Hoops right next door? You're not seeing the customer who might have been at Rick's at Hoops instead.

Eric Langan – President and Chief Executive Officer
We see benefits. What we're seeing is Hoops—we've been doing some promotions. We had Nick Diaz at Hoops for UFC. The place was so packed that Rick's got overflow from Hoops. Same thing with some of the other weekend nights. Hoops is not a very large place so when there's big games and stuff if they get too busy, Rick's is actually getting a benefit from it. So far so good.

Q: Okay, great. Congratulations. I'll let somebody else get on.

Operator
Our next question comes from the line of Bill Brown, a private investor. Please proceed with your question.

Q: Great quarter. I just wanted to get a little more color, if you will, in terms of on the tax rate, just to get a sense of the difference between if next year they dropped it to 20% or 25%, what would approximately that translate into in terms of cash?

Eric Langan – President and Chief Executive Officer
Phil, do you have that handy?

Phil Marshall – Chief Financial Officer
No, but you could probably take pre-tax income and take that 10% difference and assume that's going to turn into cash.

Q: Okay. And that's how much? What is the pre-tax income for the year?

Phil Marshall – Chief Financial Officer
This year is around $14 million.

Q: Okay, great. So it could be as much as $1.5 million or so, next year. Great, thank you.

Operator
Our next question comes from the line of Evan Tindell of Bireme Capital. Please proceed with your question.

Q: In Q4, Bombshells had, I think it was an extra $500,000 or $600,000 of revenue but adjusted operating income was flat or I think it was down a tiny bit, down $100,000. Do you guys expect Bombshells as it continues to grow—you guys have seen a lot of operating leverage in the past, I know it's just one quarter. Do you guys expect to have more operating leverage there?

Eric Langan – President and Chief Executive Officer
Webster was a big hit in that quarter because we knew we were closing it. Once it was rumored, sales got even worse. We tried to reduce hours first to try to make it work, but that didn't help either. And so we finally just closed the location. I think you'll see that in this quarter, October, November, December quarter you're going to see a much better run rate of the Bombshells. The Webster location was a drag from day one. We didn't make money there. We probably should have closed that location much sooner. We tried a B location out that was a destination location and for restaurants that just doesn't work.

Q: Okay. And for your capital expenditure plan, obviously your maintenance cap ex is only a small fraction of the overall capital that you have spent the last few years. Like, last year you guys acquired $22 million of real estate. I know a lot of that was just one or two clubs. But, my question is going forward, do you see yourselves making that big acquisition of real estate where you chunk off $10 million or $8 million?

Eric Langan – President and Chief Executive Officer
It depends on if we do an acquisition of clubs. Yes. In other words, if we do a multi-club acquisition where we buy six or seven locations from another operator and we can buy that underlying real estate, we will buy that underlying real estate as well. So you'll see that.

But as far as from our own locations, we do lease two of our locations in New York City still. They're very long-term leases, but for the right price, we would buy either of those locations. You may see a difference. But overall, I think it would be like the Tootsie's transaction and the Rick's New York transaction. You'll see that through those our overall costs will actually decline. Because of our access to bank financing, at 5% money, we can typically buy it and basically own it cheaper than we can rent it right now.

Q: Okay. And it was $5.4 million, I think the 10-K said of general corporate cap ex. Was that all related to the headquarters move or was there anything else in there?

Eric Langan – President and Chief Executive Officer
I believe that was all the corporate offices. Is that correct, Phil?

Phil Marshall – Chief Financial Officer
Yes. That's about it.

Eric Langan – President and Chief Executive Officer
I don't think we did anything else this year. We didn't buy anything else this year other than our own stock.

Q: Okay, great. That's all I have. Thanks.

Operator
There are no further questions over the audio portion of the conference. I would now like to turn the conference back over to management for closing remarks

Gary Fishman – Investor Relations
Thank you, Eric, thank you, Tim.

Please, everybody, turn to slide 17. Here is our reporting calendar for the balance of this year. Again, tonight, you can meet Management at Rick's Cabaret New York from 6:00 to 8:00. If you haven't RSVP'd, ask for me at the door. We'll also be giving tours of Hoops that we talked about on the call.

We currently plan to announce first quarter club and restaurant sales on January 10th, and first quarter results on February 9th.

On behalf of Eric, the company and our subsidiaries, thank you and good night. We'd also like to say a special thanks to our growing number of retail and institutional investors. And as always, celebrate the holidays by visiting one of our clubs or restaurants. Thank you.