Transcript of RCI Hospitality Holdings Inc.
Third Quarter 2016 Earnings Call and Webcast
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Participants
Eric Langan – CEO and President
Phillip Marshall – CFO
Gary Fishman – Investor Relations

Analysts
Andrew D'Silva – Merriman Capital
Adam Mikkelson – Cooper and Company
Kevin Casey – Casey Capital
Richard Keim – Kensington Management
John Rolfe – Argand Capital
Steven Gart – John Locke Capital
Norman Sarafian – RBC Wealth Management
Alex Hardman – private investor

Presentation

Operator
Greetings and welcome to RCI Hospitality Holdings Fiscal 2016 Third Quarter Conference Call and Webcast. [Operator instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host Gary Fishman, who handles investor relations for RCI.

Gary Fishman – Investor Relations
Thanks, Rob. Everybody, if would you please turn to slide 2. I want to remind you of our Safe Harbor statement posted at the beginning of our conference call presentation, to remind you that you may hear or see forward-looking statements involving 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 on this call as a result of developments which occur afterwards.

I would appreciate if you turn to slide 3. I also direct you to the explanation of non-GAAP measurements that we use and are included in our presentation and news release. Finally, I would like everyone in the New York City area to join us at Rick's Cabaret in New York tonight 6:00 to meet management and get a firsthand look at one of our flagship clubs. Rick's Cabaret in New York is located at 50 W33rd Street between 5th Avenue and Broadway. It's around the corner from the Empire State Building. If you haven't RSVP'd yet, ask for me at the door.

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

Eric Langan – CEO and President
Thanks, Gary. Good afternoon, everyone. Please turn to slide 4. Results in our third quarter continue to improve. Revenues increased 1.5% year-over-year. That's the first quarterly increase this fiscal year. EPS came in ahead of expectations at $0.27, which included an additional $1 million in tax reserves. This compares with $0.78 last

year, which included a big gain from the Texas patron tax settlement. More significantly, on a like-for-like non-GAAP basis, EPS was $0.34 for nearly a 10% year-over-year increase.

We achieved our third quarter 2016 performance due to improvements at existing units and the previously announced elimination of underperforming units.

Free cash flow performed well. At $6.4 million, it was up close to 50% over last year. As of the 9 months, we have generated free cash flow of $16.7 million, exceeding the low end of our most recent target. As a result, we are revising our free cash flow target upwards for the second time this year to $19 million to $21 million.

We continue to buy back shares. We bought back more than 100,000 shares, returning $1.1 million to shareholders. As of the 9 months, we have bought back more than 600,000 shares, returning $5.8 million to shareholders. This makes the fiscal 2016 buyback the largest annual buyback ever for us. And this week the board of directors declared the fourth quarter cash dividend of $0.03 per common share.

Please turn to slide 5. For those of you new to RCI, we are guided by our capital allocation policy. We've updated this slide for our slightly lower share account due to buybacks, the pay down on convertible debt, and an increase in our free cash flow run rate to approximately $18 million. Using this as a base, we calculated the after-tax yield of buying back our own shares. For example, at $10 to $11 per share, where the stock has traded recently, buying back shares generates an after-tax yield of free cash flow of 16% to 18%. We consider this yield risk-free since we are buying our own assets which we know very well.

Based on that and to adjust for risk, we require a return of about twice that should we decide to buy or open a new unit. For example, at $10 to $11 per share, if we decided to buy or open a new unit, we would want to have a return of about 33% to 36%. To be clear, this doesn't mean that we will no longer buy clubs or open new restaurants, but at this time the opportunity has to be exceptional and fit our capital-allocation model. Conversely, if a unit is underperforming in line with our capital-allocation policy and efforts to improve it have not worked, we will take action to free up as much invested capital as possible for a more profitable use.

As for paying down high cost debt, it is only in the $21 to $22 range that it makes sense on a tax adjusted basis to pay down our remaining 13% debt at an accelerated rate assuming no prepayment penalty. Again, this doesn't mean we wouldn't do so at this time, it's just that there has to be a very compelling reason for us to do so. Having said that, we are always looking for ways to refinance our high-interest debt at lower rates.

Please turn to slide 6. This slide gives you a status report on our share buyback program. As you can see, we have bought back a significant amount every quarter this fiscal year. As of the 9 months, we have greatly outpaced what we did last year and in prior years. As of June 30, 2016, we had $5.8 million remaining on our share repurchase authorization.

We bought fewer shares in the third quarter than in previous quarters this year, so I would like to address that. Buying back shares is a long-term strategy for us. We have not changed our policy. When buying shares, however, we want to maximize the use of our cash. We do not want to chase the stock price. As a result, we may buy more shares in some quarters than in others. For example, in the third quarter there was a big increase in the stock price. We paused our buying. Once the trading activity began to settle, we resumed our purchases.

In line with our buyback policy going forward, we are generally going to make repurchase announcements when we announce quarterly and annual results. This is opposed to announcing them in our quarterly sales news releases and then providing another update when we announce quarterly results. We might make an exception, for example, if we are having meetings with investors or making presentations and we believe it's appropriate to issue an update. But in general, we'll report just four times a year rather than eight.

Please turn to slide 7. Revenues continued their sequential improvement. As you can see, total revenues have gone from being down 2.1% year-over-year in the first quarter to being up 1.5% in the third quarter. Same-store sales have gone from being down 6.3% to a small increase year-over-year.

Sales were up nicely in April and then fell off in May due to heavy rains in Texas and then rebounded in June. You should note, we have had two fewer units this year relative to the year ago quarter. In addition, two clubs that were undergoing remodeling or reformatting were opened midway through the third quarter.

Please turn to slide 8. Here is an analysis of our revenues by product line. The top table presents our quarterly results this fiscal year. The bottom table shows you the year-over-year change. As you can see, we maintained our quarterly increase in beverage sales throughout the year at most clubs and restaurants. With regard to high margin service revenues, we have meaningfully reduced the year-over-year decline. As for food, we have virtually eliminated the quarter decline we saw at the beginning of the year as our newer Bombshells have come back from their typical post-opening fall-off.

Please turn to slide 9. Operating margin is continuing to move in the right direction. As you can see, non-GAAP operating margin has risen throughout the fiscal year. After being down three percentage points in the first quarter, it's now up close to two percentage points in the third quarter. The improvement largely reflects two factors: the increase in sales, in particular high margin service revenues in beverage, and reduced costs as a percentage of revenue.

We want to provide a little bit more detail on taxes. Our effective tax rate this quarter was 43% compared to 35.5% a year ago. The quarter included a $1 million reserve established to pay for New York City and state income taxes. In turn, this was partially offset from the benefit of $250,000 in FICA credits not previously claimed, which we discussed last quarter.

Please turn to slide 10. As anticipated, occupancy costs continued to fall in the 3rd quarter. This is one of our largest fixed costs. During the 3rd quarter it declined to 8.1% of revenue as compared to 8.4% in the first quarter of the fiscal year and a year ago quarter. This was primarily due to a full quarter net benefit of the Rick's Cabaret New York real estate acquisition in mid-January. The loan used to finance the acquisition increased interest costs as a percentage of revenue, but the savings in rent were even greater. Occupancy costs as a percentage of revenue should continue to decline due to revenue growth, anticipated refinancings, which should help reduce average interest paid on debt, and principal pay down.

Please turn to slide 11. This was a good quarter for our cash generating power. Adjusted EBITDA increased close to 7% year-over-year, and free cash flow increased close to 48% year-over-year to $6.4 million. We calculate free cash flow as operating cash flow less maintenance capex. As a result, as I mentioned earlier, we are raising our fiscal 2016 free cash flow target to $19 million to $20 million from $16 million to $19 million. You should note, the fourth quarter is typically one of our smaller quarters for cash generation.

You will also notice cash on our balance sheet was higher at $10.5 million versus $9.1 million at the end of March. Our practice is to have $6 million to $10 million on the balance sheet at the end of every quarter, so this is nothing more than being at the higher end of that range.

Please turn to slide 12. Here are nightclub segment results. Sales of $28.3 million were just under the year ago quarter with 38 units in operation compared to 40. Non-GAAP operating income was $9.3 million compared to $9.1 million. As a result, non-GAAP operating margin expanded to 32.9% of sales compared to 31.8%. We believe this continues to demonstrate the improved model we have been working on to expand margins. That should benefit us as our sales continue to grow.

Please turn to slide 13. Here are our Bombshell segment results. Record sales of $5 million were up 13% compared to the $4.4 million in the year ago quarter, with five units in operation in both periods. Operating income was a record $905,000 compared to $370,000. Operating margin was up strongly to a record 18.1% of sales compared to 8.3%. As I mentioned earlier, we are seeing the benefit of growing sales from new units after they have worked through the typical falloff after their grand opening. As a result, not only are sales growing, but margins are as well.

There are a lot of other things we are doing to grow the business. Our newly redesigned menu and new menu items have been a contributing factor. Our new menu recently won the Printing Industries of America award for graphic excellence, both on a regional and national level. That put us in competition with major restaurant chains such as Chili's and brands owned by Laundry and Darden. With regard to franchising, we are now in the process of putting together a franchise marketing sales team.

Please turn to slide 14. We want to give you an update on our debt. During the third quarter, we continued to significantly reduce our convertible debt. This has an average weighted rate of 8.3%. At June 30, we had an outstanding balance of $1.6 million. Following a $460,000 cash payment in July, the current balance now stands at $1.15 million. We plan to pay off the remaining amount in the fiscal first quarter of 2017. This will eliminate all the possible dilution from these issues.

The only new debt was drawing down $1.6 million on our bank construction loan for our new corporate headquarters. Construction remains on schedule for moving in during the first quarter of fiscal 2017.

We continue to work on refinancing two commercial mortgages as part of this transaction we are now looking at. We are looking at rolling over commercial mortgage of $6.2 million at 7.2%, and paying off $2.5 million of unsecured debt at 13%. That's a little less than what we originally anticipated, but nonetheless, on a combined basis this refinancing and debt pay-down would meaningfully reduce our interest expense.

We also have some real estate that is no longer needed and hope to complete their sales in fiscal 2017. Proceeds would be used to buy back stock, finance growth or pay down debt.

Please turn to slide 15. Here we have updated our long-term debt slide. There are a few things this quarter I would like to point out. Compared to March 31st, we saw small reductions in balances and rates in total long-term debt, debt secured by subsidiary stock, the Texas Patron Tax Settlement, debt secured by other assets, and a major decline in convertible debt. The only area of debt that went up was debt secured by real estate, but less than $1 million and the rate declined there, too. The percentage of long term debt backed by real estate is now 70% versus 64% six months ago making our debt position even more secure. The average weighted rate on all of our long-term debt has now fallen to 7.53%

Please turn to slide 16. Here we have updated our debt maturity schedule. As we explained last quarter this is intended to show three key elements to our debt management. One, we plan for a regular amount, currently in the $7 million range, for amortizations to be paid annually out of cash flow. Two, a good portion of our debt maturing over the next five years is related to real estate amortizations or real estate balloons. We plan to refinance all non-amortized debt. Three, any non-realty balloons would be paid out of cash flow or otherwise refinanced. For example, the new refinancing I discussed on slide 14.

The new refinancing will eliminate all balloons in fiscal 2017. It will also eliminate $2.5 million of the 2018 non-realty balloon. We anticipate refinancing the remaining 2018 balloon debt during 2017.

Please turn to slide 17. To wrap up, on our first quarter call we told you we were off to a good start with plans for margin and EPS growth and free cash flow generation this year. On our second quarter call we told you were moving in the right direction.

With this call you can clearly see continued improvements in our results on a year-over-year basis reflecting the ongoing implementation of our new model. This should enable us to post favorable year over year comparisons through the fourth quarter.

Consequently, we believe we are on track to achieve our fiscal 2016 goals and possibly exceed them with regards to free cash flow. For revenues that means we expect the fourth quarter to be up slightly. For margins that means improvement for the year and an increase in GAAP EPS. For free cash flow that means reaching our new target.

Looking ahead to fiscal 2017, we are very encouraged. We will have the full-year benefit of the reopened clubs. We will also have the new club in New York, as well as the new Bombshells in Northwest Houston. We are pushing their openings out of quarter - no major issues, just the timing of a few final things.

In addition, we believe we will benefit from a strong sports lineup. The NBA is not holding its All-Star game in Charlotte as originally scheduled. However, in the first quarter the Minnesota Vikings will be returning to the new stadium in downtown Minneapolis where we own three major clubs. In the second quarter, the Super Bowl will be held in Houston where we will have seven locations, both clubs and Bombshells. In addition, mixed martial arts events are coming to Madison Square Garden for the first time. These events, based on their locations, we anticipate, could add significant incremental high margin sales.

With our capital allocation policy, improved operating performance, continued share buyback, dividends and contributions for our investment banking and investor relations teams, we hope to see further recognition of our shares in the market. The stock is up more than 4% from our last call, more than 5% year to date and close to 38% from our year-low of $7.60 on February 16. We believe that’s a good indication that our strategy is working. We have had productive meetings with institutional investors in New York in May and Dallas in June, but we know there is still more work to do and we are dedicated to making it happen.

Speaking on behalf of all 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 lines for questions. Operator.

Operator
At this time we will conduct our question and answer session. (Operator instructions)

Our first question comes from Andrew D’Silva with Merriman Capital.

Q: Good afternoon and thanks for taking my call. Just a few quick questions here. As it relates to the dynamic of patrons you are seeing in the club business, are you still currently seeing big spenders continuing to gain a percent of your overall sales? And have recent changes in oil prices or Brexit changed anything in your view at this point?

Eric Langan- CEO and President:
The big fish were still at the clubs, as we said in past calls, but what we were seeing is less use of the VIP rooms, which was is a big service revenue item for us. As you can see, in this quarter and in the last quarter, we are starting to see that spend come back. It is still not 100%, but I am certainly hoping, if not in this fourth quarter, definitely the October to March period, I really expect to see a lot of that come back.

In terms of oil, we were affected in a couple of areas in Odessa and Longview, Texas. Other than that we haven't really seen much. We have kind of absorbed it everywhere. If we have seen the effect, we have absorbed it. Overall sales seem to be coming back. Obviously, the restaurants in Houston and Dallas were unaffected by it at this point, unless it's helping them because people have more money because gas is cheaper, but as far as the oil industry itself, it's not having an effect.

Q: Great! And then as far as the new location in New York, do you still feel the location can generate between $5 million and $7 million in annual revenue and $1.0 million to $1.5 million in initial EBITDA to you guys annually?

Eric Langan- CEO and President
Yes. That's still our projection at this time.

Q: Last question. As far as M&A activity for gentleman's club has that changed much since the last quarter? And if not, are you seeing that clubs are looking to exit at lower multiples since there hasn't been much activity and is it getting closer to your capital-allocation strategy targeted returns?

Eric Langan- CEO and President
If we were still doing $15 million I would say, yes, but we raised the model to $18 million because we think that is a more likely run rate at this point, so it's getting tougher to find the acquisitions that meet that. However, depending on the leverage, because we are basing it on our cash on cash returns. We are starting to see some things that are appealing to us, but at this point we haven't moved on any of those.

Q: Have you seen any M&A activity in the market that you are aware of at this point, even with smaller clubs? Or is it still pretty dry right now?

Eric Langan-CEO and President
Pretty much it's pretty dry. I have seen some other finance stuff out there for some small locations, but nothing significant at this time.

Operator
Our next question comes from Adam Mikkelson of Cooper and Company.

Q: A few questions. Just on the restaurant margins, they've come up quite a bit. Is there any particular reason why they're so high and what do you expect to see those settle at as you bring on more units?

Eric Langan – CEO and President
The reason they are so high is we have two stores that are performing extremely well. They actually would be higher. We have one location that we are not real happy with right now. We have reduced some hours there, trying to change some stuff up to see if we can make that store profitable. If not, we will probably end up closing that location at some point, which will increase the margin. But our sales have been really good. The new menu has been real strong for us, as you can see from the increase in food sales from two quarters ago. We are just very happy with the overall performance. Of course, the fixed costs are the same. As we have that additional revenue, especially on the liquor side of it, so much of it makes it to the bottom line and that's why you are seeing the margins increase so much.

Q: Without that other unit in there, what kind of margins would you be targeting?

Eric Langan – CEO and President
Over 20%.

Q: And just in general, what are you seeing in Texas? What are you seeing in the economy there?

Eric Langan – CEO and President
Home prices are still crazy. Construction is still crazy. One of the issues that we are having right now, both with New York and in Texas is just getting all of our inspections done. Cities are getting backed up again on inspections. We were getting inspections in three days. Now it's taking five, seven, ten days just to get our inspections, and it's taking longer to get our permit approvals pushed through. Especially in Texas, we're seeing it everywhere in Texas. Even if we try to do a little remodel permit or anything we're trying to do down there, we're seeing that time lag out. So, if the Texas economy is hurting, somebody forgot to tell people in Texas.

Q: Okay. My final question is just on the buybacks. So you had $6.4 million of free cash flow in the quarter. You had $1.1 million of buybacks. The volume hasn't been great in terms of the stock and in terms of your ability to buy it back, I guess, but you have a company which on the equity side is running at about a 20% free cash flow margin with your operating guidance. So, is there any ability to accelerate the buyback, just given the cheapness of the stock? Could you look at a tender offer? Are there other ways to accelerate what you're doing?

Eric Langan – CEO and President
I'm sure there is. Right now we've just kind of been in the market when we think the stock's cheap and it doesn't look like there's any other – it may look like a lot, you know after the conference call a lot of buyers moved in and we're not trying to compete with other people that want to own part of our company. So we kind of stepped out of the market in May.

As the volumes dwindled back down and the price started coming back down, we got back in the market pretty heavily and bought quite a bit of stock, especially at the end of June. As you've seen from our slight mistake in our spreadsheet because we bought so much right there at the end, it didn't carry right or something, but we corrected that and got that information out to you.

We've been active in July, we've been active in August. Any time the stock is under $10.50, we're going to be very active out there.

With the new numbers, we're probably going to be active. Even if the stock jumps up this time, we'll probably stay active in August. It's just to the point where it's just so cheap again. Even at $18 million, I think we're going to exceed $18 million. That would only be another $1.3 million in cash flow in the quarter; we might have done that in July. So, I'm just going to have to watch it.

We're at the top end of our cash. We're trying to keep our cash on hand and in place, just in case and opportunity for a block or something comes up. We'll want to make a move on something like that. There's a lot of opportunities out there for us to buy back the stock. And like I said, we're looking at getting these restaurants open, getting New York open.

We're also looking at some of our underperforming – I wouldn't say underperforming, but units that just based on the investment aren't returning high enough returns for us and we may divest ourselves of a couple of locations, because those locations take time for management, they take effort. But the capital allocation policy, with the strategy and the map, we're able to really sit down and use the map on that and say, well gee, if we could cash this for this, we could take it and put it someplace else and get higher returns.

Q: We certainly support the results of the capital allocation strategies are revealing for you and keep it up. Thanks.

Eric Langan – CEO and President

Thank you.

Operator
Our next question comes from Kevin Casey with Casey Capital.

Q: I noticed that your math to figure out what level it takes to pay off debt dramatically moved up to something like the high teens to the twenties. What are the drivers for that?

Eric Langan – CEO and President
Well, when you raise the base from $15 million to $18 million, and you lower the share count from 10.3 million to just under 9.9 million, and you figure your free cash flow you'll get buying back the stock, it becomes much higher. So, therefore, it would take a much higher stock price to lower the free cash flow yield on buying back stock to the after tax yield of paying off the debt.

Q: So if you keep lowering the share count, it's going to keep going higher?

Eric Langan – CEO and President
If the price stays the same, yes. Because the yields going to become higher and higher.

Q: Can you talk a little bit more about Bombshells, how many more locations do you need to start franchising? Where are you with franchising partners? Are these going to be like one or two locations, or are you talking to people that want like five locations?

Eric Langan – CEO and President
We're in early stages right now. We've been talking with a few groups. Really what we've discovered is we need a sales team or a sales person, who specializes in selling $3 million franchises, because the franchise fee is $50,000, but you still have to build out and do everything, so it's about a $3 million investment on average is what we're going to get. So we have to find somebody who has experience doing that.

We're in talks with someone at this time. We'll know more shortly. If we hire this person, I'm sure we'll do a press release on it. If it doesn't work out, then we have a couple of backups that we are starting to work on as well. But we're aware of that we need to do and we need to get that person out into the franchising shows and on the circuit, and just get our brand out there. So we're in the process of putting that all together now.

We could franchise in all 50 states today. We just need the salesperson who can close the deals. And I think when we open our new store, that's going to help a lot as well. We're going to be able to show another deal. Plus, when we update our franchising stuff, we'll be able to put some more financial data out there.

Q: Can you talk about why, I guess two locations are just killing it on the upside and then you talk about the one that's struggling. What are the puts and takes from the successful location versus the non-successful one?

Eric Langan – CEO and President
The non-successful location was our second location. It was a B location. We have been talking about issues with that location for several months, like two calls now. We've been very unhappy with the performance there.

Two of our locations are performing kind of within the realms of what we want them to do, $60,000 to $80,000 a week in sales, which is $3 million to $4 million annually. But we have one unit that's probably in the high 6's and now a second unit, which is the oldest, the very first unit we opened, we put new management in there about a year ago and they've really taken that location to a new level. It's doing very, very high numbers and we're very happy to see it. Sales are up. I think we've had months that are up 70% year-over-year. Overall, I think we're up over 50% year-over-year in that location.

Now with the two older stores coming back and then of course our number one store even had a decline, but it was still very profitable, but even had a small decline from its opening and now it's building back up and starting to surpass the opening numbers as well. That's what you've seen in this quarter when four of our locations doing very, very well and what that means to the bottom line numbers.

Q: Can you talk about capex for the rest of the year and next year?

Eric Langan – CEO and President
It should be right in line with where it's been. In fact, it may even be a little less. We have fewer units. I don't expect anything major. We could lay some carpet every now and then, some chairs every now and then. So there's just not a ton of capex out there.

Q: Great. Thanks.

Operator
Our next question comes from Richard Keim with Kensington Management.

Q: Nice numbers. However, I have a question. How come legal is still up when you were talking about it coming down?

Eric Langan – CEO and President
I noticed that before. We've had some activity in a couple of suits. Remember, we still have several of those insurance suits out there from when the insurance company went bankrupt. I think it was just normal activity. It wasn't up much; it wasn't up significantly, but it was up a little bit. But it was still in line with the percentage of revenue that our target is right now.

Q: Are you going to make a commitment to bring legal down or is it going to stay at these relatively high levels?

Eric Langan – CEO and President
We do what we can do. We keep the costs in line as much as possibly can, but I think right now, at least for the next couple of quarters, we're probably in this range. June was a very active month for a few of our lawsuits and that just jumped the numbers up a little bit.

But they're staying in line. Typically, I guess they're running around $180,000 to $225,000 for our actual legal plus our standard stuff that we have no control over. We're going to have those fees every quarter for being a public company.

Q: Second question was New York. I think you said it's going to open in the fourth calendar quarter, meaning the first quarter of your new year. Is that—

Eric Langan – CEO and President
No, in this quarter we're in right now. Hopefully before the end of September. So it will be our fourth quarter fiscal '16 and we're moving the other–. No, no, you're right. I'm sorry, we did move it, didn't we?

Well, we're hoping to open by the end of September, but it could be the first of October. That's the confusing—I think that's why we pushed it a month on the thing. We're trying to open before the end of September, but just in case, we pushed it a quarter because it could be early October.

Q: Are you essentially done except for the inspections?

Eric Langan – CEO and President
There's some minor construction that you can't do until some of the inspections are done, but yes, we're ready to go, everything's done. The final finishes have to be done after the last inspection. So we're waiting for an inspection now, then we'll do the final finishings and then we'll get our Certificate of Occupancy inspection.

Q: So if I said to you, your inspections are done today, when could you open?

Eric Langan – CEO and President
It would probably take them about two to three weeks to finish all the final finish out, and then when we get that last inspection again.

Q: Okay. Thanks and good luck. Keep up the good work.

Eric Langan – CEO and President
Thank you.

Operator
Our next question comes from John Rolfe with Argand Capital.

Q: I was hoping you could maybe put a little more color around the increase in your free cash flow guidance. It looks to me, I think before the year started you said you expected the topline to be flattish, and it looks like it will come in, in that range. So is the increase in free cash flow a function of margins coming in better than you expected? Is it a function of better working capital management, lower capex or all of the above? What are sort of the components that have been driving those improvements in your expectations there?

Eric Langan – CEO and President
We've really got a handle on all the costs that we can get our, you know, get our minds wrapped around it. We can kind of control. We're seeing an increase in the service revenues, which is definitely going to help margins. And we got rid of the underperforming units; units that we were carrying that were costing us a lot of cash to keep those units open. So by eliminating those units and keeping the numbers – so the gross is flat, but we're doing it with fewer units, so our costs are lower on generating that revenue. Then, of course, we're not paying to keep clubs open. You get a double bang for it that way.

Q: Great. One other question. You mentioned that the tax rate for the quarter was higher as a result of some accruals for New York. What should we be thinking going forward in terms of a sort of fully-loaded tax rate on an ongoing basis as we look into next year?

Eric Langan – CEO and President
I feel we're going to roll back to about that 35% to 36% range.

Phillip Marshall – CFO
It will be more like 36% or 37% now.

Eric Langan – CEO and President
Okay. To give you an idea, we brought in some tax experts at the beginning of the year and they've gone through all of our returns and started looking through everything, and basically we just wanted to double check everything. We've grown very large, kind of outgrew the ability of the earlier company, and these are just some of the things,

actually two of the things that they found that one was in our favor and one wasn't, and they're correcting it and we'll get it fixed and everything will get back to normal in 2017.

Q:Thanks very much.

Operator
Our next question comes from Steven Gart with John Locke Capital.

Q: I just have a kind of forward-looking question. In an ideal world, if everything went your way in terms of business plan and it's, say, 2-2.5 years out from now, what is the mix of Bombshells versus the nightclubs from a revenue contribution? Just roughly how many clubs, how many stores of each? I'm just trying to get a sense of where you're trying to drive this thing to over the next two or three years.

Eric Langan – CEO and President
The reality of it, it all depends on where our stock price trades at because we're going to follow our capital allocation policy. If our stock moves up, we're going to have more of that free cash flow to invest, we're going to end up doing more units and we'll probably make more acquisitions and grow the company. If the stock price stays where it's at, we'll probably add a club a year, a few restaurants possibly in a year. The thing about franchising, franchising could blow that up.

In a perfect world, as you were saying, you had me dreaming for a minute. I thought, "Apple's going to give me $3 billion." They're offering it to everybody else out there these days.

Q: Right after Zuckerberg – Dare to dream.

Eric Langan – CEO and President
Yes, sir. But I think we're going to try to continue to keep this steady growth rate in addition to buying back shares. And the shares are going to continue to see a growth rate in the bottom line, EPS. We'll just have to watch how the market goes. We're going to continue to follow the strategy. I think eventually the market will catch on, we'll start being rewarded for managing our cash in a much better way than we've done in the past, and being conscious of those returns, and I think we'll start being rewarded for those returns. And as we're rewarded for them, we'll be able to go out and grow and do more clubs. We're going to be doing them under a much more disciplined strategy than we did in the past.

Q: That's good to hear. If things did work out well, the stock responds well to the capital allocation policy and just the decent results you're having, do you see the potential of eventually just moving the restaurants into B-shells and keeping the clubs like Rick's and spending all for doing something like that? Creating almost like –

Eric Langan – CEO and President
We're going to try to create the most value we can create from our assets and from our cash flow. So if the market, at some point, doesn't give us any value for the restaurants and we think we can get more valuation for the restaurants by spinning them off and they become significant enough to do so, then we'll spin them off to our shareholders and let people benefit in that way.

Q: Thanks a lot. Congratulations on your results.

Operator
Our next question comes from Norman Sarafian with RBC Wealth Management.

Q: Yes, again, congratulations. A great quarter. I enjoyed seeing the progress and I think you're doing just perfect.

The thing that concerned me a little bit, though, in general is that incident down in Orlando, Florida. I got nervous because I was thinking, "I wonder how safe we are" in terms of going anywhere. It's kind of a weird feeling. What is the method or how do you think about this, or do you, with respect to the clubs and the restaurants and things just in general? Or is it an issue at all?

Eric Langan – CEO and President
We have armed security. It's always on our minds, like everyone else in the world, I think, nowadays. I was reading about the London stabbing this morning. I was thinking, "Man, it just doesn't matter – guns or knives." The problem is the crazy people.

We have armed security at most of our large locations. We use police details, so we actually have police officers from the community that guard our properties when they're available. Obviously, all cities won't work with us in that regard, but the ones that we do, we're very, very thankful for. Those are the locations we have the least amount of problems at, because we have professionals handling security.

Even our third party security guards, they do very well at keeping our places safe. We put in cameras and monitoring systems and some clubs have checkpoints. Some clubs we have pat downs and metal detectors like you're going to the airport. You just do what you can do and plan for the worst and hope for the best.

Q: Good. I'm glad to hear you're thinking it through. That's great, Eric. Thank you.

Operator
Our next question comes from Alex Hardman, a private investor.

Q: Good afternoon. Congratulations on the positive trend quarter-after-quarter. Good to see it. It's been a long time.

The first question, you brought in some tax professionals. Does that go into legal and professional category, I take it?

Eric Langan – CEO and President
I would believe so, right? That is where that's, correct, Phil?

Phillip Marshall – CFO
They are.

Eric Langan – CEO and President
Okay, thought so.

Q: So that would be why that cost hasn't really dropped that much this quarter. I mean, it's pretty much in line with last year.

Eric Langan – CEO and President
Yes, there are some new costs in there. But I think we're being protected much better than – not that we weren't in the past, but we wanted to bring in some experts that have worked with multi-club and multi-state jurisdictions and make sure that we're doing everything right everywhere.

Q: Understandable. This might have been asked earlier, but I was wondering if you could give an update on Robust?

Eric Langan – CEO and President
There's a lot of things going on with Robust. That's one of the things that we may look at divesting soon. We just don't know, we're looking at all of them. Like I said, we're looking at our capital allocation model, we're applying it to different things. We have some club units that we think we could maybe, depending on if we can find a buyer for, we may sell a couple of club units. We may close one of the restaurant units. We're evaluating our non-club and non-restaurant assets as well. We're going to do that through the end of this year and figure out the best things on a move forward basis and what we're going to do with those things.

Q: Regarding Robust, I know you guys bought an interest in that company. You were talking about basically paying forward your energy drink usage and stuff. Have you got any attraction outside of your own clubs?

Eric Langan – CEO and President
They've launched in Florida. They've launched in Minnesota. They're launching a few other markets now. Picked up some extra distributors. We have gone with one single company that's now distributing in Texas, or the majority of Texas major cities for us. So we're seeing some traction there, but we're working on doing all the manufacturing here in the US. We have the "bag in the box" product now. So it's not all bad news, but it's not all good news. It's kind of a mix right now. We just have to decide whether it fits our capital allocation policy on a go forward basis or not, and decide what to do with those assets.

Q: Thank you very much.

Operator
Ladies and gentlemen, we have reached the end of our question and answer session. At this time I would like to turn the call back to Gary Fishman for any closing comments.

Gary Fishman – Investor Relations
Thank you, Rob, and thank you, Eric. Please turn to slide 18. Here is our reporting calendar for the balance of the year. Again, tonight you can meet management at Rick's Cabaret from 6 p.m. to 8 p.m.

Next week, we'll be at the 23rd Annual Gentlemen's Club Expo in New Orleans and we'll be holding our annual meeting also in New Orleans. The second week in October, we report fourth quarter club and restaurant sales. The third week in October, we are planning to do some institutional meetings in Florida and then present at the Dawson James Second Annual Small Cap Growth Stock Conference in Jupiter.

The first full week of December, we'll be at the L.D. Micro Investor Conference in Los Angeles. And the following week we'll report fourth quarter and yearend results.

On behalf of Eric, the company and our subsidiaries, thank you and goodnight. We'd also like to say a special thanks for our growing number of foreign investors in Brazil, Israel, Germany and Denmark. And as always, please visit one of our clubs or restaurants. Thank you, everybody, and goodnight.