Transcript of
RCI Hospitality Holdings, Inc.
Second Quarter 2017 Earnings Call and Webcast
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Participants

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Gary Fishman – Investor Relations

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Kevin Casey – Casey Capital
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Presentation

Operator
Good day ladies and gentlemen, and welcome to RCI Hospitality Holdings Fiscal 2017 Second Quarter 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. [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. Sir, the floor is yours.

Gary Fishman – Investor Relations
Thank you, Kat. Please turn to slide 2 everybody. I want to remind you that our Safe Harbor statement is posted at the beginning of our conference call presentations. 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 that occur afterwards.

Please turn to slide 3. I also direct you to the explanation of non-GAAP measurements that are used and are included in our presentation and news release. Finally, I'd like to invite everyone in the New York City area to join us tonight at 6 o'clock to meet management at Rick's Cabaret in New York, Manhattan's number one gentlemen's club, and tour its sister club, Hoops Cabaret & Sports Bar next door. Hoops Cabaret is located at 50 W. 33rd Street between Fifth 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?

Eric Langan – President and CEO
Thank you, Gary. Good afternoon everyone, and thanks for joining us. If you'll please turn to slide 4. After the market closed, we announced our second quarter results for Fiscal 2017. We delivered another solid performance. On a GAAP basis, we earned $0.39 a share. That compares to a year-ago quarter when we earned $0.54, which included a $1.75 million tax credit. On a non-GAAP basis, EPS increased 5.1% to $0.41, compared to $0.39 in the year-ago quarter.

Free cash flow did very well. As of the six months, we've generated $10 million, nearly equal to what we did in the year-ago period, which again, benefited from the tax credit. As a result, we are on track with our initial $18 million fiscal '17 target.

We already reported some of our revenues, but I'd like to point out a few items. Same-store sales continued to be ahead of last year, up 2.7%. In particular, our high-margin service revenues increased 7.3% year over year. Due to the disposition of underperformers in the fourth quarter 2016, same as the last quarter, total revenues were up less than 1%.

In line with our capital allocation strategy, as our share price has increased, we held back on share repurchases and renewed our focus on acquisitions in the second quarter of '17. This resulted in today's announcement of the purchase of Scarlett's Cabaret Miami, which we expect to meaningfully increase revenues, EBITDA, and free cash flow. In addition, we announced the April 26th acquisition of Hollywood Showclub Cabaret and real estate, providing a low cost entry into the greater St. Louis market.

If you'll please turn to slide 5. Our focus at RCI continues to be growing free cash flow. Thus, our capital allocation strategy 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 going into fiscal '16. It is a mathematical formula that has fundamentally changed our approach to every decision we make, and here's how it works. We have two major uses for cash. One is buying or opening new units. We target a hurdle rate of 25% to 33% cash-on-cash return to account for the risk of making a new investment, absent an otherwise strategic rationale.

Two is buying back shares. At $17, where the stock has been trading, buying shares generates an after-tax yield on free cash flow of 10.9%. As a result, at today's stock price, we are more inclined to find acquisitions that meet our hurdle rate and add to free cash flow versus buying back our shares. To be clear, this does not mean that we will stop buying shares. We certainly want to be prepared to step into the market aggressively should the stock price weaken or should the yield increase from our new acquisitions.

There are two other parts of the strategy. 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. Also, only at a much higher stock price does it make sense on a tax adjusted basis to pay down our most expensive debt prior to maturity. Having said that, we are always looking for ways to refinance our high interest debt at better rates.

So please turn to slide 6. This morning we announced the acquisition of Scarlett's Cabaret in Miami for $25.95 million. From a strategic point of view, Scarlett's is one of the best gentlemen's clubs in the country. It is complementary to our biggest club, Tootsie's Cabaret in Miami, which is only five miles away. And it significantly expands our position in South Florida, which has been a great market for us.

Terms of the agreement, which has already closed, were as follows: We made an immediate payment of $5.4 million. We will make another $5 million payment in six months. For the balance, we're giving the sellers an 8%, 12-year note that is fully amortizing. For tax purposes, the parties have elected to treat the transaction as an asset purchase, which under current law, would enable us to lower future tax costs and enhance cash flow.

From a financial point of view, we believe Scarlett's will become a major and immediate contributor. In physical size, it's the second to our largest club, Tootsie's Cabaret. We anticipate revenues will rival Rick's Cabaret in New York, our second largest revenue generating unit. And for the trailing 12 months, we estimate Scarlett's generated $13 million in revenue and $6 million in adjusted EBITDA. Based on these results and how we have structured the transaction, the club is expected to yield an initial cash-on-cash return in line with our capital allocation strategy.

Please turn to slide 7. Last month, we announced the acquisition of Hollywood Showclub and other assets in the greater St. Louis market. From a strategic standpoint, we saw this as a unique opportunity. It was a way to provide a low cost entry into another top 20 market and gain a foothold in the Midwest.

Terms of the two agreements, which we've already closed, are as follows: The first was $1 million for the assets of Hollywood Showclub, a 12,000 square foot venue currently in operation. The second was $3.2 million for three pieces of real estate: The Hollywood Showclub building and land, an adjacent property for opening another club, and a nearby building and land which we will either lease or enter into a joint venture third party club operator.

From a financial point of view, Hollywood Showclub will be accretive although it's relatively small. However, based on financing the real estate, we anticipate the initial cash-on-cash return to be in line with our capital allocation strategy. Longer term, we believe we can grow the St. Louis market into another meaningful contributor to the company.

Please turn to slide 8. We also have five new units opening between this quarter and the beginning of next year. We have already opened two. The first was a Studio 80 dance club in Webster, a suburb of Houston. The first Studio 80 in Ft. Worth is doing very well and tables for Saturday nights are booked six weeks in advance. The concept capitalizes on renewed interest in music from the 1980's MTV era. The second was Foxy's Cabaret in Dallas. The first one in Austin is doing very well. Foxy's is a late night BYOB concept that is designed to attract a more upscale demographic. To be clear, Studio 80 Webster and Foxy's Cabaret Dallas are re-concepted units taking advantage of an existing lease or real estate we already owned.

And then we have the three new Bombshells in the Greater Houston area. The first, opening later this month, will be on State Highway 290. It is designed to replicate the success of one of our top units located in another part of Houston. The second one is scheduled for August, and the third for January of 2018.

Please turn to slide 9. Total revenues, total club and restaurant sales and same-store sales continue to outperform year-ago levels. Sales continue to benefit from positive trends developed in the second half of fiscal 2016. Revenue reflected a 2.7% increase in same-store sales and a 1.5% increase from new units. In turn, this was partially offset by a 3.7% decrease from the elimination of underperforming units and the energy drink business in the fourth quarter of 2016. Of note, higher margin service revenues continue to rebound, making this the third quarter in a row of year over year and the fifth consecutive quarter of improvements. We expect these positive trends to continue in general over the balance of fiscal 2017.

Please turn to slide 10. Non-GAAP operating margin was virtually level year over year at 22.2% compared to 22.7%. On the upside, gross profit margin continued to expand, growing to 85.6% of revenues, mainly due to increased share coming from higher margin service revenues. We also saw an overall improved performance in our operating segments and had lower depreciation and amortization expense. On the other hand, in preparation for growth through acquisition and new units, we added managers, recruited staff, and initiated training programs.

As the new clubs and restaurants come online, we'll have the revenues that will go against these costs, and we should begin to see increased operating leverage.

Please turn to slide 11. Here are the segment results for nightclubs. Sales were up 2.1% on one less club while same-store sales increased 2.7%. VIP spend continues to look like it has returned. We saw strong results from our three units in Minneapolis, even after the professional football season ended; from Club Onyx Houston, with the Super Bowl being played in that city; and at premier clubs, such as Tootsie's Cabaret in Miami and Vivid Cabaret New York. Non-GAAP operating income was up more than 8% with margins up 200 basis points.

If you'll please turn to slide 12. Here are our segment results for Bombshells. Revenues declined 5.5% on one less unit. Same-store sales increased 3.2%. This continues to be pretty impressive considering most comparable chains in the industry had soft results in the first calendar quarter. Our performance combined with the closing of the Webster unit in the fourth quarter significantly expanded bottom line segment results. Operating income increased more than 8% while operating margin expanded 240 basis points.

With regard to our franchise marketing program, we had an excellent reception at the Multi-Unit Franchising Conference in Las Vegas the last week of April. It provided us with significant third party verification of our concept. Operators from around the country liked our theme, design, economics and the all-American welcoming, female-friendly approach. Most importantly, we developed some strong qualified leads. To support our marketing efforts, we produced a promotional video and brochure which are posted on our bombshellsfranchise.com website. I encourage you to check it out and see what the concept is really about.

Please turn to slide 13. This slide reviews our cash generating ability. Adjusted EBITDA—This was down about $300,000 due to investments in people and training that I mentioned earlier. Free cash flow—At $10 million year-to-date, our free cash flow is actually up year over year if you exclude the benefit of 2016's tax credit. Cash at $13.2 million—Cash was up more than 9% from December 31st. That reflects our performance even after payments of large routine tax bills in the second quarter. It also includes the sale of non-income producing property in January net of paying down the related debt.

Please turn to slide 14. Along with buying back shares over the past year, we have also paid off our convertible debt. As we reported on our last call, during the second quarter we paid off the last tranche of convertible debt that we had outstanding, a $400,000 seller financed note. This eliminated 40,000 potential shares. We now have no dilutive securities remaining in our capital structure.

Please turn to slide 15. Here's our long-term debt slide. There are three changes from the last quarter. Through the current mix of properties, the amount and percentage of our real estate debt declined slightly from the end of the first quarter. As I mentioned, we paid down the remaining balance of convertible debt so that slice is gone. We looked at the debt slice that was labeled secured by subsidiary stock and divided that into two pieces. The first reflects what is truly parent-level debt, which totals less than $10 million. The second is non-real estate seller financing, which is tied to the performance of the relevant unit or units sold to us. As of 3/31, the only finance we have like that was less than $10 million that related to Jaguars' acquisition.

Next quarter you'll see the effects of three new pieces of debt, one of them temporary. We added $5.4 million to parent company debt, which we raised to help with the initial cash payment for our acquisitions. This is from the issuance of 12% unsecured promissory notes that mature in three years. They pay interest only in equal monthly installments with a lump sum principal payment at maturity. We have the second payment to Scarlett's of $5 million temporarily on the balance sheet until the payment is made, and then we'll have the Scarlett's seller financing.

If you'll please turn to slide 16. Here we've updated our debt maturity schedule as of March 31st. You can see how it has become very manageable from our point of view. Annual debt amortization is around $8 million, with a small $2.3 million non-realty balloon to take care of in 2019. We have larger realty balloons in 2020, but based on the properties involved, we expect to be able to refinance or extend them.

Please turn to slide 17 for our outlook. Our core plan for the balance of fiscal 2017 remains the same—follow through with what we started in fiscal 2016. We will continue our approach to capital allocation in everything that we do. Second half sales should continue to benefit from the positive trend developed over the last 12 months. And the second half should also benefit from our two new clubs and our two new Bombshells, and perhaps the sale of our first franchises.

In addition, our recent acquisitions, in particular, Scarlett's, should have a beneficial effect. In light of that, I know that many of you want us to adjust our free cash flow target, in particular. We plan to do that on our third quarter call. We'd like to operate the clubs for a little while before we commit to what we think the performance in the second half will be. In addition, during the first half, we sold one of our non-income producing properties at a price in line with our expectations. And during the second half, we anticipate the sale of some of the other non-income producing properties. Although nothing can be assured, we have three properties under contract. We expect the seven remaining pieces to generate an estimated $10 million.

On behalf of Rick's management and our subsidiaries, I'd like to thank our loyal shareholders for their support. And let's open the line for questions. Operator?

Operator
Thank you. The floor is now open for questions. [Operator instructions]. Our first question comes from Frank Camma from Sidoti. Frank, go ahead.

Q: Hi, Eric.

Eric Langan – President and CEO
Hi, Frank, how are you doing?

Q: Congratulations. A couple questions. First on Scarlett's, since it's so meaningful, the EBITDA percentage that you are kind of indicating from the adjusted trailing 12 months, pretty high obviously in the north of 40%, so when you compare that to your base business—granted it doesn't have any corporate allocation or anything. So could you just talk about how much—is it much of a premium above your existing high-end clubs? Can you just talk about that purely from a margin basis?

Eric Langan – President and CEO
Sure, actually it's a little lower. If you look at Tootsie's at $24 million, it's about at $11.5 million in EBITDA and then Rick's New York at about $14 million in revenues with about $7 million in EBITDA. I think Scarlett's is just a little bit lower. I'm hoping that we'll see a little bit of expansion there as we come in. We should be able to lower some of the costs with our national pricing with some of the alcohol producers, the beer companies, and other national pricing that we get. I'm hoping that will help some. And then, of course, putting some of our cash handling and cash management systems in to monitor the cash handling, I'm hoping we'll see a little bit better margins out of that.

Q: Okay, good, good. Because it seems like it's a pretty well-developed club and is my understanding right, that you wouldn't have much incremental corporate G&A given the fact that you have a club relatively close to that location?

Eric Langan – President and CEO
We should have none because we've been preparing to go back into acquisition mode for a little while, which is why the salaries were up just a little bit. And, it's in Miami, it's close to our other location. Our director of operations lives down there, so it should be absolutely minimal cost, if any at all, to bring this right into the fold.

Q: Okay, great. My second question is just on Bombshells, since in the press release the quote is "and the possible sale of our first Bombshells franchises," so are you kind of hinting that you're getting close on that?

Eric Langan – President and CEO
I would say that we've met with several parties. We are in the due diligence phase. They are in the due diligence phase, but we really got excited at the Las Vegas franchise convention. We got some very solid leads on some very solid multi-unit operators that run other full-service restaurants. So I think we're—there's a lot of interest. I think it just kind of shows us that we're on the right path and long-term, waiting for the right first and second candidates for franchises is going to pay off for us.

Q: How long would it take them from when they execute a contract or whatever, what you do expect from that until when they actually open their first restaurant?

Eric Langan – President and CEO
Depending on if they do a convert or they do a ground-up build, it could be anywhere from 6 to 12 months.

Q: Okay, great. Thanks, guys.

Operator
And our next question comes from Ishfaque Faruk from WestPark Capital. Go ahead.

Q: Hi, good afternoon, Eric. Congrats on the excellent quarter. A couple of questions. Your service revenues have been doing very well of late. Do you think they can keep up the momentum?

Eric Langan – President and CEO
They typically slow down a little in the summer, but I think that right now the trend for the high-end spend is great. We're in May. We really won't know until about mid-June when school lets out and we kind of go through that little bit of change how it's going to be. But I expect if it slows down, it will slow down a little. I think it will still be up year over year, but it may not be as strong as this quarter. Typically our first and second quarters are our strongest quarters and then we slow down a little bit July through the end of September, and then the April, May, June quarter is a little slower. But I really think that with the that way things are trending right now, that October through March of next year are going to be really fantastic for us.

Q: Alright, okay. In terms of big club acquisitions, I know you guys just announced Scarlett's. Do you guys have similar sized ones in the pipeline in the upcoming months? I know you have talked about it multiple times in many different places. Do you have similar negotiations going in place?

Eric Langan – President and CEO
We have several targets that we're looking at and talking with right now. It really will depend on how the stock performs here and how quickly we want to move forward, and of course, the negotiations on down payments and owner financed paper because obviously depending on how much cash we need, I think we're going to have the ability to raise whatever cash we need if we are bringing these in. I think most of the multiples are going to be better or similar. I don't see us paying more than 4x for anything. This deal was basically a 4x deal. And then we covered some of the expenses associated with the—they had to recapture depreciation in order to consider their

stock as an asset purchase for tax purposes. And so we covered some of those costs for them, which brought the price up a little bit. But it will save us a lot of money over the next 15 years.

Q: Alright. Thank you, Eric. And once again, congrats on the quarter and the acquisition.

Eric Langan – President and CEO
Thank you.

Operator
And our next question comes from Kevin Casey. Kevin, go ahead.

Q: A couple questions. First Scarlett's. Can you talk about the different clientele from your other location that's kind of close to it?

Eric Langan – President and CEO
Sure. You know Tootsie's has more of a Vivid—from a New York standpoint—more of a Vivid type, more blue-collar clientele, where the Rick's New York is upper-end clientele. Scarlett's and Tootsie's are very similar to Vivid and Rick's in New York. I think Scarlett's has a little more upscale clientele, where Tootsie's—

Q: And then can you talk about, is there any performance metrics on the seller note where it would change if they don't hit certain milestones?

Eric Langan – President and CEO
No, it's a straight up 12-year amortization based on a 4x trailing 12 months adjusted EBITDA.

Q: And then the focus and the pipeline on acquisitions, did that increase? I know you're very focused on that at the last trade show. And did these, the two acquisitions in the quarter, come about because of that or are these people you've been talking with for a long time?

Eric Langan – President and CEO
Well, we've been talking. The St. Louis deal is definitely because of the stock price going up, but when we really got interested is when the stock price broke through 13, we really started realizing, if we can find the right 3x multiple deals, we should be looking at them instead of continuously keep buying back more and more stock. We still think the stock is cheap, but when we can get a 3x EBITDA deal there, and we've definitely been looking at some of the larger acquisitions like Scarlett's. We've said all along, we want to buy premier clubs. We want to buy some of the top clubs, and I think Scarlett's is definitely one of those. It was very, very well run prior to us buying it. It's been in operation for a long time, had a great reputation, and I think it's just a fantastic fit for us and being in that South Florida market.

Q: Is there any competition in buying the assets? When you look at future acquisitions, is there any competition? Other buyers?

Eric Langan – President and CEO
I'm sure there's people out there. I don't know that they have cash and I don't think they have the track record we have. I think we have a distinct advantage, but I would never say there's no one else out there. I would just say that right now we're the preferred acquirer. I think that the guys that are looking to sell their clubs, especially if they're trying to create an annuity, which is almost the only way they can sell, it's nice having a publicly traded company behind that annuity, especially with strong cash flow that we have.

Operator

Our next question comes from Steven Gart from John Locke. Steven, go ahead.

Q: Hi, Eric. Congratulations. Those are nice results. Having followed the company for about 12 or 13 years now, there's been some challenges when you've gone big on the acquisition cost as opposed to the nip and tucks that you've proven really, really capable of integrating well. I guess, you're a lot bigger now. I guess Florida's also market you know pretty well, but do you foresee any issues with this acquisition that you ran into with Vegas? Anything on the regulatory front? And I am actually curious if it's already run so well, seems like you're getting it a pretty good price, and that just be market price, but are the current owners aging and just they wanted that annuity to exit?

Eric Langan – President and CEO
There were three owners. I think they all had different reasons for wanting out. I know the main guy—he's spending most of his time in the Bahamas now. I think that as far as a Vegas-style transaction for us, this is nowhere near a Vegas-style transaction. Vegas was a very competitive market, where South Florida may be competitive, but it's still grandfathered licenses. There's not much risk of new competitors. It's got a solid freeway location. You've got the casino expansion going on. The new tower will open in 2019, which is right up Hollandale Road. I mean from that standpoint, I don't think that this outranks any other acquisition that we've ever done other than Tootsie's. I think it's just such a rock solid market. It's got such a long history. One of the things with the Vegas transaction was they only had about three years history. I think what we're looking for now, like I said, are grandfathered locations with long operating histories and solid year after year cash flow generation.

Q: Okay, great. Alright, thank you. Good luck with it.

Eric Langan – President and CEO
Thank you.

Operator
And our next question comes from Darren McCammon from ProActive Financial. Go ahead, Darren.

Q: Hi guys. Nice quarter.

Eric Langan – President and CEO
Hi, Darren, Thank you.

Q: You've answered some of my questions, but I've got some housekeeping here. So Scarlett's. Did that happen after the quarter was closed or before?

Eric Langan – President and CEO
We just closed yesterday, yesterday afternoon about 4 o'clock.

Q: Okay, so you had $13.2 million in cash when the quarter closed. The five-point-something million that you gave them, you took on debt for that or you used cash?

Eric Langan – President and CEO
We took on debt for the $5.4 million because we used $4.2 million to close the St. Louis transaction on April 26.

Q: Okay, so you're probably around $10 million now, something like that.

Eric Langan – President and CEO

Yes, I'd say somewhere around that. I'd have to pull it all out. Give or take $500,000, we're in the $10 million range in cash on hand.

Q: Okay, that's where I was trying to get. Okay, thank you.

Eric Langan – President and CEO
We do expect to get $2 million back when we refinance the property. We're going to get a bank loan against the real estate in St. Louis. We paid cash for ease of closing the transaction. So it will take us about 90 days or more to get the appraisals and everything that goes to get the bank financing on that property, but we're starting that process.

Q: That'll make it $12 million again. And so you say you have other deals in the pipeline at 4x EBITDA?

Eric Langan – President and CEO
We have deals that we're looking at between 3x and 4x. Some may be a little under 3x.

Q: Do you feel you have the access to cash to continue doing these?

Eric Langan – President and CEO
We raised $5.4 million with a few phone calls, so I mean I think from a debt standpoint, absolutely. From a free cash flow generation standpoint, obviously we've got to come up with the $5 million. I don't want to borrow the $5 million for the second six-month payment. I want to pay that out of cash flow. We're not going to look at equity at all. But I think right now, with this transaction and the Bombshells, as I said we're at $34 EBITDA on a trailing 12-month run rate. This adds $6 million. That puts us to $40 million plus. I think as long as we stay at 3x EBITDA on our total debt, that I'm comfortable with using debt to continue to do these types of deals.

Q: Okay, thanks. That answers that question. So on this Scarlett's deal, you didn't buy the real estate. That's kind of a departure for you guys. Why is that?

Eric Langan – President and CEO
Well they have a 21-year lease. It's at a great, great price. We did talk about buying the property. We valued it at one value. He's got a little higher value on it. We have 21 years to sort it out. We didn't see any need to press the issue at this point. We had to come up with a 20% down payment on the real estate to get the bank financing, or 25%, so we'd had to come up with more cash up front. With 21 years, it just didn't seem like the right timing to pursue the real estate. Like I said, we've got a long-term locked in lease. The grandfathered license with an RCI subsidiary is the only one that can operate a cub there under the license. So we're pretty confident that we'll work that out with the landlord down the road.

Q: Okay, but the landlord is the seller of the club?

Eric Langan – President and CEO
No, the landlord is not the seller of the club. It's a third-party landlord.

Q: Okay, okay. Also, I think you already answered it, but I'm just going to go ahead and ask it anyway. You've already done $10 million in the first half. By my calculations, Scarlett's is going to do another $1 million a quarter. Do you think the $18 million is a little low?

Eric Langan – President and CEO
Yes, but we're not prepared to give you a new number yet. So we're going to continue to use the $18 million for our purposes right now, and we plan to adjust that for sure by August and we may internally adjust it a little

sooner as we start seeing results from June and July. But I think we'll have a nice solid idea of where we're going to be. Keep in mind we have a Bombshells opening at the end of this month. We just did the St. Louis location. We've got two new re-concepted locations that are open, so it's just really hard to come up with a solid number. We know we've got a range in mind, but we don't have a solid number at this point. And we don't want to speculate what that number is going to be until we have a little more information. So definitely by August—by the next conference call—we will make the adjustment and probably give an estimated go-forward run rate as of August. So that will give you some insight into 2018 as well.

Q: Fair enough. That's a good point about the other stuff you've got opening. Again, great quarter guys, at 4x EBITDA, great purchase.

Eric Langan – President and CEO
Thank you.

Operator
And our next question comes from Evan Tindell from Bireme Capital. Evan, go ahead.

Q: Hi, how's it going, guys? Congratulations on the deal. One question I had was it looks like Scarlett's got sued a couple years back by the dancers. The headline said it was like a $6 million settlement having to do with whether they were contractors or employees, etc. I think that issue is in the past and the dancers will have a similar setup for your other clubs. Is that how you guys are looking at it?

Eric Langan – President and CEO
Yes, they had the same issue we had back with Rick's New York. It's been handled and settled, and they have treated the entertainers as contractors going forward with contracts that we think are protective, very similar to the ones we use. We're also indemnified from any claims prior to us taking over. We don't believe there's any risk there for us.

Q: Okay, and when you said that the South Florida market is a grandfathered market, does that mean basically, that just means that they haven't been granting any new licenses for a long time, but Scarlett's is grandfathered in, basically?

Eric Langan – President and CEO
Correct. They actually have a settlement agreement from a lawsuit with the city. And it was modified to include us as the operators as part of this transaction. So we're very excited to be able to go in and be able to purchase this location and bring our management team—along with the management team that's existing there right now. We really don't see us changing a whole lot other than not being absentee owners. I think the owners were kind of absentee as of late. I think they'd made up their mind to sell a while back. We'll do some minor remodeling, new carpeting, update some chairs, and some other stuff that's just basic maintenance that's been probably let go a little longer than it should have been as the owners were looking to sell. So we'll get all that stuff back up and have a first class operation there.

Q: Okay, got it. Basically another company would not be allowed to not just operate Scarlett's but what would be the process if another—?

Eric Langan – President and CEO
Well, they have an ordinance in town that our settlement agreement, I think, exempts us from. I have to look at the whole situation, but it's very difficult. I'm not saying it's impossible. You might be able to find a location, but I don't think you're going to find a location on 95 at the Hollandale exit or anywhere that's as economically viable as this location.

Q: Right. And do you guys look at how they perform during the financial crisis like '07/'08/'09, that time period? Did the club still perform pretty well? That's one of the good things about you guys—

Eric Langan – President and CEO
Yes, I don't have their numbers, but I have ours from Tootsie's. We've only went back about three years at their numbers, and we're very confident that we'll have no problem continuing with at least $13 million of revenue and $6 million in EBITDA. And we're hoping to expand on that a little bit, which we'll have a better feel for by August.

Q: Okay, and the 8% seller financing, that sounds like, given the multiple you guys are paying and everything, it sounds like not a bad deal, but did you guys consider—well it seems like a good deal actually, but did you guys think about or talk to any banks about just paying them in cash and maybe getting bank financing for $15 million or is that just too much for the banks to stomach? What do you guys think about that?

Eric Langan – President and CEO
I don't think the banks are prepared to finance our clubs yet. We do have bank financing for the Bombshells, for our restaurants, and our real estate. In fact, we just closed a deal on the Bombshells in Pearland where we're financing 80% of the construction costs and FF&E. So I think we're getting there, but I don't think we're ready for the banks just yet to finance the club acquisitions for us. I think there's still some headline risk there for them, and I think they are still shying away from that. I think as we continue to grow and our cash flow gets stronger and stronger, if nothing else, we'll be able to start tapping more of our real estate equity and using that real estate equity to make the acquisitions of the clubs with.

Q: That's probably one of the reasons why you guys can buy things at 4x EBITDA because the banks won't finance you guys or anyone else.

Eric Langan – President and CEO
This is a high-priced deal for us. Three times is our typical purchase price. In fact, most of the offers we go out and make are at 3x. This was a very unique situation, and with the owner financing component, it made a lot of sense even at 4x for us on a cash-on-cash return basis, and so we were comfortable making it 4x, especially with the licensing situation in that market. So it's a unique market for us as well.

Q: Got you. One more question. I was just looking at the breakdown of the segment operating income. It looks like you guys had the general corporate expenses were I think it was a negative $3.5 million versus a negative roughly $2 million in last year's quarter. Operating income overall was pretty flat, so I'm just wondering, was there kind of a move of expenses from the nightclub segment to the corporate segment? Looks like that might have been the case, or was there any particular thing you'd call out?

Eric Langan – President and CEO
We're working on our ERP system, which adds a bunch of cost and also, we moved into our new corporate office, which was a move from a 9,000 square foot building to a 39,000 square foot building. We were basically at about 150 square feet per employee in our old office, so we definitely had to remedy that.

Q: Okay, great. That's all I've got guys. Thanks.

Operator
And our next question comes from Terry Gardner from CJ Lawrence. Go ahead.

Q: Thank you. Eric, just two questions confirming on Scarlett's. One is 21-year lease on the property, that's 21 remaining years?

Eric Langan – President and CEO
Yes, 21 remaining years.

Q: Thanks. And then it's an all cash deal? You wouldn't consider using any equity as part of the transaction?

Eric Langan – President and CEO
No. We are not using any equity at these multiples. Our free cash flow yield on our equity is still 10.9%. So when you take the interest deduction that we get from financing at 8%, it's just so much cheaper money to use debt than equity right now.

Q: Sure, sure. And then, finally on Scarlett's, with the two clubs fairly close together, yes they're different brands, can you just discuss maybe what type of cost synergy you get out of having two facilities located so close together? Is there a potential that EBITDA climbs just based on some cost benefit of having that geography so close?

Eric Langan – President and CEO
Sure, we won't pick up any oversight management costs because they are so close. So there's no oversight management cost. I think we're going to pick up, like I said earlier, our national pricing. So we'll get national pricing from our soda, liquor and beer vendors, which will help lower costs. I think with the marketing budgets that we have, we'll be able to go to the radio stations and buy cheaper time because we're buying for two locations instead of one. It's always worked very well for us especially in the Dallas-Ft. Worth market, having multiple locations. So we'll get those types of synergies. But the main thing, this club is already very profitable. So any incremental savings goes straight to the bottom line.

Q: Got it. Thank you. And then finally, if you could remind me, on the Bombshells slide, you're down one unit versus last year. What were the circumstances surrounding the reduction in units? I know you're going to be opening new ones, but why'd you go from five to four?

Eric Langan – President and CEO
Well the second unit we opened, we opened in a B location, and it was before we really knew the restaurant business. We thought these restaurants were just like the gentlemen's clubs. We can make them a destination location, and we got really good rent. We learned really quick that restaurants are not necessarily destination locations, and they do much better when we're surrounded by other restaurants in a class A restaurant type environment. So we just decided that we weren't making money at that location. It was not something that was long term going to be a successful restaurant for us.

We only have a five-year lease. We had 19 months left on it. It was cheaper for us to close the location than it would be to continue to operate it. And since we had to pay the rent for the next 19 months anyway, and Studio 80 was doing so well for us in Ft. Worth, our managing partner up there came down and kind of looked, and said hey, I think this location would be a great Studio 80, and it was relatively inexpensive to reformat it. I think around $100,000 to reformat it. So we just reformatted and reopened it since we had to pay the rent anyway. And we were able to take all of the furniture and fixtures out and use them in the Pearland location. So it saves us money there.

Q: Great. Thank you very much.

Eric Langan – President and CEO
Thank you.

Operator
And our next question comes from Steve Martin from Slater Capital. Go ahead.

Q: Hi guys. Most of my questions have been answered. Can you talk about what you think the new Bombshells are going to look like in terms of revenue? You seem to be doing about $1 million per quarter or a $1.1 million per quarter per unit.

Eric Langan – President and CEO
Yes, I think they're going to be very similar. The 290 location, I think, is going to be rock star location for us. We've expanded the patio there with about a 3,100 square foot patio, incorporating a giant oak tree that was on the property into the patio. We covered about half of it, so we get use of it even when it rains. Really it's just been a fantastic—we've taken everything we've learned from our other ones and put it into this one. It's a ground-up build for us. Even though it's a land lease, we decided to go ahead and spend the money to do a ground-up build here. It's before we had the bank financing for the restaurants.

I think it's going to be a fantastic location for us. The Pearland location, I think, probably going to be an average $4 million restaurant for us. And then the I 10, the third location, which won't open until January, I think, based on the demographics, is going to be another fantastic location for us. What we've learned on the restaurants is we don't have to open up base hit restaurants. We're swinging for the fences on every one of the ones were doing right now because we know what the demographics of our restaurants are. We know where we do the best with the best demographics, and so those are the locations we're looking to open. And we'll just go to a new market versus going into a location that we're not 100% sure.

Q: Okay. Can you talk about the Texas market and the related oil patch issues? I know you had some troubles when oil turned down, and what is that looking like today?

Eric Langan – President and CEO
Yes, we had some of them in Longview and Odessa. We've bottomed out in Longview. Odessa's been coming back for about eight months now, so we're seeing some nice numbers in the Odessa market again. The Longview market may take a little bit longer. That East Texas crude has still got a little ways to go.

Q: Okay. Going back to Miami, what is the competitive environment like now that you have sort of the two big clubs in the area?

Eric Langan – President and CEO
There's a big late night club that's in downtown Miami in South Beach that probably competes with our really late night business. Lunch is probably pretty standard lunchtime market for us. Other than that, I don't think we really have a lot of competition in that market.

Q: Now that you have both of them, will that allow you a little pricing flexibility?

Eric Langan – President and CEO
I think it would. We're not looking at increasing anything through price increases at this point. I think right now we're just looking at—they really didn't compete with each other. Scarlett's and Tootsie's have two different demographics, two different entertainer bases, and that's why it was so exciting when we were able to pick up this location because we already competed for totally different markets. When we go to Dallas-Ft. Worth and bought clubs, we were buying clubs that all competed for the same market, and we had to go in and rebrand them and re-concept them and make them compete for different markets. Tootsie's and Scarlett's already did that on their own. So there's really not much operational changes we have to make, if any at all.

Q: Okay. You made a comment about them not marketing very aggressively. Is that something you plan to change?

Eric Langan – President and CEO
Yes, we'll definitely start building the lunchtime and happy hour business back up. We'll definitely work on the higher-end hotels and a marketing program for the higher-end hotels. And, of course, the late night business, we'll be pushing for the late night business again and some of the dance club business. It's got a dance club portion of the building as well. So we're going to work on those things that they've kind of let slide a little bit, and I think once the new casino tower opens up at the Hard Rock, we're going to see a significant amount of increase from that as well.

Q: What are current business trends like in the quarter, just in general?

Eric Langan – President and CEO
In general, they've been pretty positive. We're seeing steady same-store sales increase. We're seeing the service revenue increases. Obviously, June is always a time we get seasonal, so I'd like to see how this seasonal adjustment comes in June. But I think we're set up in most of our markets for a very strong summer based on some of the marketing trends and some of the things we've been doing.

Our teams are stronger than ever. We brought in a new guy in February for vice president of operations to basically assist Ed in managing the Texas locations. He's now helping out in the St. Louis location as well. I think we're going to see him do a little more traveling for us as the Dallas-Ft. Worth market is gaining strength for us with some of the new management people he's brought in. We're just very optimistic about the teams we've put together over the last four or five months.

Q: Okay. One last question. Within your SG&A last year, and I think earlier this year you had some insurance settlements. Where are you on the curve on those going away or declining on a year over year basis?

Eric Langan – President and CEO
I think you've seen most of the settlements gone. I mean we're always going to have little things here and there. We self-insure the first $75,000 of all of our GL risk now ourselves so that we can pick our own attorneys and kind of control our cases. So they're not just giving $50,000 to every single person who said they slipped and fell on our locations. We're actually being able to get video and make sure people are telling the truth. So that's helped, and we're hoping that will help lower insurance costs as well.

Most of the uninsured cases are gone. I think there's still a couple out there, but nothing—all the fatality cases are gone. We've got some smaller claim cases that we're still dealing with, but overall, you've seen our legal costs are starting to come down a little bit, they're flattening out. And I'm hoping that as we move forward we'll see that they even come down a little more.

Q: Okay. Thanks a lot.

Eric Langan – President and CEO
Yes, thank you.

Operator
And our next question comes from Peter Siris. He's a private investor. Peter, go ahead.

Q: Hi, Eric. I have a couple questions. First on the Scarlett's, in the press release there was a comment about using the Scarlett's name in other locations. I'm asking about using the Scarlett's name at other locations, but at the same time, do you see going forward over the next number of years, using other names more branding across your group of clubs or just keeping it pretty much the way it is?

Eric Langan – President and CEO
We probably are going to change the St. Louis club into a Scarlett's. We've got a couple of other locations around the country that we have one-off brand names on that we are contemplating using the Scarlett's name. We want to use the Scarlett's name as our party brand. Originally, when we talked with Vivid, that was kind of the idea, to use the Vivid name as our party brand name. But since we have to pay for that name and we own the Scarlett's name, I think we are much more inclined to use the Scarlett's name and rebrand some of our locations and kind of build the party club brand name out of that location, leaving Rick's as our upscale brand. While Scarlett's in an upscale brand compared to Tootsie's, it's still a party brand because Miami is a party town. So it's a little different than some of the other markets that we do business in, even for the upscale market, because it's late night. They're open until 8 am on Friday and Saturday. I don't stay out until 8 am anymore.

Q: I don't stay out until 8 pm anymore. The logic tells me that with the way people travel and do business that there should be brand leverage from developing a couple like Rick's, Scarlett's, a couple of these major brands. Do you envision there could be brand leverage going forward?

Eric Langan – President and CEO
I mean, I think so. With the internet and with the traveling customer, absolutely. If you go to a place that you party at all the time in your hometown and you end up in another town and you see the same name, you kind of know what to expect when you get there. So I think that definitely helps. One of the other things is club licensing is doing a little bit better than it was with Scores and Penthouse both licensing their brand name. We may consider with the Scarlett's brand, actually licensing the brand name to third-party operators as well and building a nationwide network of clubs that we use social media and the Internet to market and promote.

Q: I want to come back to this 3x EBIT that you purchase things at. People who own these clubs, they really don't have—sort of like what happened in the automobile industry—a lot of those people are getting older and it seems to me they don't have a lot of places to go. Is that a reasonable view?

Eric Langan – President and CEO
Yes. There's just no exit strategy. I mean, your exit strategy is to sell it to your managers and carry a note. There's no cash buyers out there. Even we're not really a cash buyer. We can come up with a significant down payment, and we can buy out the small guys—like the St. Louis location, a single club operator there. We can buy out those clubs for cash. But there's just not a lot of cash buyers out there. Our business has changed. I was in the office the other day saying how did I get an office job? A lot of our job is dealing with accountants, dealing with auditors and tax people and attorneys. It's become a corporate business, no different than the casinos. We've always talked and we've always compared for the last 15 years the casino industry. If anything now, we're definitely becoming more and more like the casino industry in that we're dealing in the real world.

Q: But say the top five players in your industry own what share of the market?

Eric Langan – President and CEO
Top five, revenues or locations? Revenues probably 15%, locations maybe 10%, not even 10%.

Q: That's probably the lowest I could imagine. So do you see going forward that you would try to grow faster? I mean I know you've just made two acquisitions, but do you see significant growth opportunities in terms of—I mean if you can buy things for 3x or even 4x EBITDA, that's got to be highly accretive.

Eric Langan – President and CEO

It all boils back down to keeping our debt level to a 3x EBITDA or less and what our equity does. I think the deals are out there. We're looking at them, but at the same time, if all of a sudden our stock is giving us a 15% or a 13.9%, a 15.9% yield, why do I need to take risk? I can just buy back my own stock and not take any risk. So we're watching those things.

I think overall, definitely the growth is out there. The deals are out there. I think they're going to heat up even more now that we've made this serious acquisition of this size. We hadn't really done a lot in two to three years, so basically everybody thought the opportunity to sell their locations and cash out or create a solid annuity, which is the way I look at the owner financing deal we do is basically we're giving them a 12-year annuity of 50% to 60% of their free cash flow is coming back to them for the next 12 years while they figure out what they're going to do. I just think we're the only ones that can do that at this time.

Q: Great. Thanks a lot.

Operator
And our next question comes from Robin Bansal from Bansi Capital. Robin, go ahead.

Q: Yes. I am curious, why did you decide to start Bombshells instead of continuing to acquire businesses like Scarlett's?

Eric Langan – President and CEO
Well, about 4 years ago or so we were in the heat of this lawsuit in New York City, and we had financial advisors who told us diversify, diversify, diversify. So we opened up a few concepts. Two of them are no longer around, and Bombshells was a hit and it seems to have legs. So we've really started a new business that's working very well for us.

Q: Do you anticipate starting any new concepts as well?

Eric Langan – President and CEO
No, not at this point. We got lucky with Bombshells. We're not out trying to get lucky. We're following a capital allocation strategy. We're buying solid cash flow or we're building it through the Bombshells brand. I don't see us—if we did something it would be because we see a long-term cash flow advantage to us, and we'd buy it at the right multiple that meets our capital allocation strategy. But at this point, I don't know another business out there that we can buy other than the adult businesses at this three to four multiple and have the solid long-term cash flow.

Q: And so how do you evaluate the economics of opening another Bombshells versus acquiring another club?

Eric Langan – President and CEO
We look at whether there are other clubs available at the right pricing at the time. And really right now, we're going to try to open about three company store Bombshells a year. We're going to try to do those three stores with our cash, provided that we find demographics that we believe will be in line with our capital allocation strategy and being able to line up the financing and buy the property now.

Q: Don't you get a better return on your cash from acquisition versus opening a new Bombshells?

Eric Langan – President and CEO
It really depends. With the Pearland location, probably not. We're only going to have about $750,000 in cash into the location because we're bank financing the remainder of the construction and FF&E. So with bank financing we can open them up pretty cheap. If we can go in and open up a location that's similar to Dallas or our South

Houston location that's generating $1.5 million in income, we can be cash-on-cash return in six months. So the Bombshells are very exciting for us in that regard. In a worst case scenario, we're cash-on-cash in 18 months.

Q: One last question then. How big do you think is the market to acquire clubs? Do you have a sense of how long can you continue acquiring clubs?

Eric Langan – President and CEO
We think there's 500 clubs out there out of the 3,500 that we'd like to own and operate. That's 16% to 17% of the total market. When you look at other industries, 16% to 17% you're not even a market dominator. There's years left of expansion for us, unless, of course, all of a sudden we wrap up four or five of the big operators at one time or something. I think right now, you're going to continue to see us grow like we've been growing.

Q: Thank you.

Operator
Our next question comes from Darren McCammon again from ProActive Financial. Go ahead, Darren.

Q: Hi guys, a couple followups. Isn't Studio 80 a new concept?

Eric Langan – President and CEO
Actually, no. We had the Vee Lounge in Ft. Worth, and Studio 80 had been around for a long time that operated down the street from us, and they had a fire and burnt down. We we're actually talking with them about selling them the Vee Lounge beforehand. So when their business burnt down, they said, hey, why don't we just turn Vee Lounge into Studio 80? So that's kind of how the concept started. The concept's actually been around for a while.

As far as opening a second location, our total investment was about $100,000. We were able to get about $300,000 worth of equipment that was tied to the lease out of the building to re-concept it. So it was a win-win for us either way.

Q: Okay, but I'm assuming if this thing is a hit, that you could—

Eric Langan – President and CEO
We could open more, yes, I mean, I guess we could. I don't know that we're looking to, but they're relatively inexpensive to build. You just find another club location that was a previous club and you can actually do them—we turned a restaurant into one for about $100,000. So it kind of gives you an idea. It's not massively expensive to do.

They're not big revenue generators. They're only open four days a week, but they are profitable. Studio 80 is now profitable. Now that it's being operated in our building, it's profitable, where Vee Lounge was hit and miss for us from month to month. There's definitely some possibilities there. It's not something we're looking at very hard, but yes, I guess it's definitely out there.

Q: Okay, so I guess what I'm hearing is that it's kind of a one-off opportunistic thing. If it happened to be a hit, then yes, of course you'd pursue, it but it's not something you're spending a lot of time on.

Eric Langan – President and CEO
Yes. It's about cash flow for us. We'll open this up and we'll probably have our—at $100,000, we'd probably be cash-on-cash in four or five months. We'll make about $25,000 a month I think is what we're turning out of there. I'd have to go look at the numbers again, but that sounds about right off the top of my head.

Q: Okay. Back to synergies, you'd talked about an analogy of gaming, and in gaming, the frequent player clubs are a big deal. And then I can't help but think of Playboy and their old key clubs and how that might relate to you. Have you considered anything like that?

Eric Langan – President and CEO
I'll just say one word—divorce discovery. We looked at doing some type of frequent deals. It is just, long term, doesn't look viable to us. A lot of our top VIPs, they don't want everyone to know they're in the clubs. It's more discretionary than a frequent flyer card or the key club type concept in today's environment. We don't see it working. I haven't seen anybody else make it work. I'd rather see somebody else make it work and then adapt the technology to be honest with you.

Q: Okay. Fair enough. Thank you.

Eric Langan – President and CEO
You bet.

Operator
Are there any final questions? This is the last chance for questions. There appears to be no questions at this time.

Gary Fishman – Investor Relations
Okay. Thank you, Eric. And thank you, everybody, for staying on for our call, which has been pretty long tonight.

On page 18, you'll see our calendar. The next two events are our third quarter club and restaurant sales, we'll announce that July 11th, and third quarter results on August 9th. Those are preliminary dates; we'll tell you when we formalize them. Following that, the Annual Gentlemen's Club Expo will be held August 27th through the 30th in Las Vegas.

On behalf of Eric, the company, and our subsidiaries, thank you and good night. We'd also like to say a special thanks to the new investors who have been in touch with us since our appearances at the Sidoti Conference in New York City and the Planet MicroCap conference in Las Vegas. And as always, please visit one of our clubs and restaurants.