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Transcript of
RCI Hospitality Holdings, Inc.
Third Quarter 2018 Earnings Call and Webcast
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Participants

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Eric Langan – President and Chief Executive Officer

Analysts

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Presentation

Operator
Greetings, everyone, and welcome to RCI Hospitality Holdings Fiscal 2018 Third 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 Gary Fishman, who handles Investor Relations for RCI.

Gary Fishman – Investor Relations
Thank you. For those of you listening to this call on the phone, you can find our conference call presentation on the RCI website. Click the company and investor information just under the RCI logo. That will take you to the company and investor information page. Scroll down a little, and you'll find all the necessary links for the third quarter.

Please turn to Slide 2. I want to remind everybody of our Safe Harbor statement. It's posted at the beginning of our conference call presentation. It reminds you that you may hear or see forward-looking statements that involve a number of risks and uncertainties. I urge you to read it. Actual results may differ materially from those currently anticipated. We disclaim any obligation to update information disclosed on this call, as a result of developments that occur afterwards.

Please turn to Slide 3. I also direct you to the explanation on non-GAAP measurements that we use 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 six o'clock to meet management at Rick's Cabaret in New York, Manhattan's number one gentleman's club. You can also tour its sister club, Hoops Cabaret and Sports Bar, next door. Rick's is located at 50 West 33rd Street between Fifth Avenue and Broadway, around the corner from the Empire State Building. If you haven't RSVP-ed, 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 Chief Executive Officer

Thanks, Gary. Good afternoon, everyone. Would you please turn to Slide 4? After the market closed, we issued our third quarter earnings news release and filed our 10-Q. We reported another great quarter of strong core results. We are in active negotiations with club managers in multiple markets to purchase their clubs. Our newest Bombshells in Pearland, a Houston suburb, continues to do very well, and all four of our Bombshells units in development are moving ahead on schedule.

Turning to our results, we achieved record quarterly revenues of $42.6 million, up 14% year-over-year. GAAP EPS for the third quarter was $0.55, up 38% from a year ago. During the quarter, one of our subsidiaries had an approximately $500,000 lawsuit settlement. Excluding that and other smaller items, non-GAAP EPS came in at $0.58, up 24% from a year ago. Free cash flow increased 17% year-over-year to almost $8 million. Favorable trends are continuing; we believe we'll exceed our fiscal 2018 free cash flow target of $23 million, and we'll announce our fiscal 2019 target in December, when we report year-end results.

Please turn to Slide 5 for an analysis of third quarter operating performance. Compared to the year ago quarter, total revenues reflect increases of 12% from new units and 5% from same-store sales. New units included a full quarter of the Bombshells 290 in Houston, which opened in the fourth quarter of '17, nearly a full quarter of the new Bombshells in Pearland, which opened in early April, and a small contribution from the renamed Kappa Men's Club. Last year's two major acquisitions, Scarlett's Cabaret in Miami and St. Louis, transitioned in the same-store sales over the course of the third quarter. All of these translated into segment sales increases of 8% for Nightclubs and 54% for Bombshells.

In addition, all core revenue lines continue to grow, with beverage up 14%, food up 33%, and high-margin service revenues up more than 6%. GAAP operating profit increased 20.4% to $9.5 million. Key factors included big increases in segment operating margin for both Nightclubs and Bombshells. This more than offset a modest increase in corporate overhead. Non-GAAP operating margin at 23.4% was about level with last year, in part due to significantly larger contribution from the Bombshells in the mix.

Please turn to Slide 6. A variety of other factors—a variety of factors drove our performance. In general, we've benefited from the improvement in our portfolio of nightclubs and restaurants, along with increased operating leverage from higher revenues, particularly in the Bombshells segment. We have continued to see increased customer counts in nightclubs and restaurants and strong marketing around pro-basketball playoffs and the start of the baseball—and the pro-baseball season. There were some specific factors—nightclubs benefited from the economy doing well, which has been reflected in higher oil prices, which helped revitalize the Texas oil patch. Bombshells continue to benefit from interest in the Houston Rockets and Houston Astros, as well as the new menu items we introduced last quarter.

As we discussed in our last conference call, corporate overhead increased. This was primarily due to hiring vendors to develop controls, due to our new financial IT systems and produced reports automating financial analysis. Having said that, I want you to know there is a larger company we're exploring new ways to use our scale to reduce costs from vendors in areas, such as insurance. Lastly, similar to our second quarter, cost of occupancy continues to decline, and because of the new federal tax law, our effective tax rate was 20% lower than last year.

Please turn to Slide 7 for a look at our sales and margin trends over the last two years. Same-store sales are now up nine quarters in a row. This is the longest continuous quarterly up trend we've had since early fiscal 2013. In the third quarter, we started the comp against year ago increases of 6% plus in same-store sales and increases in total revenue from the Scarlett's acquisition in Miami, and the acquisition in St. Louis. In the fourth quarter, we begin comping against Bombshells 290. This is where our new Bombshells Pearland has helped sales, and our Bombshells rollout plan will also help pending the acquisition of new clubs. As I mentioned earlier, the third quarter generated record quarterly total revenues. If all goes well over the course of fiscal '19, we will benefit from both the new Bombshells, as well as any acquisitions. As for non-GAAP operating margin, as we mentioned in the last quarter's call, we expect it to moderate somewhat in the second half. In general, however, you can see we are on an upward trend.

Please turn to Slide 8. Our strong performance during the third quarter also led to strong cash generation. Adjusted EBITDA was up 14% year-over-year to almost $12 million. For the nine months, adjusted EBITDA was up 28% to more than $35 million. As for cash itself, we had more than $13 million on the balance sheet on June 30th. This was up more than 5% from March 31st and close to 33% from the start of the fiscal year. As for free cash flow, it is now up 24% for the first nine months at close to $21 million.

Please turn to Slide 9 to review our long-term debt. Debt continues to be very manageable. Compared to March 31st, it is up approximately $4 million, mainly in debt secured by real estate. There were small reductions in other types of debt across the board, and our weighted average interest rate was up five basis points.

Please turn to Slide 10. Regarding debt maturities, in the third quarter, we extended $3 million in Scarlett's Miami seller financed, non-reality balloon. It now will balloon in fiscal '19. We added $4 million in a realty balloon for property on US 249, part of which is being used for new Bombshells. This comes due in fiscal 2020, but this should be converted into a construction loan in the fourth quarter, as we start building there. The only major balloon in the next five years is the $5.4 million in fiscal '20 related to the Scarlett's acquisition. If needed, we believe we can extend or refinance this before it balloons or pay it out of free cash flow.

Even though total debt has increased with our higher revenues and lower interest rate on debt, cost of occupancy has continued to fall year-over-year. In the third quarter, it was 7.6% at total revenues, down from 8.2% a year ago. And for the nine months it was 7.6%. We added a new section to this slide on our total debt to adjusted EBITDA ratio. We'd like to keep this below 3 times. Currently at 2.95, we are close to the 3, but that's primarily due to the extra real estate we acquired around our new Bombshells. As this real estate was acquired with bank financing, and as we sell off the extra real estate over the coming months and pay down the bank debt, our debt to adjusted EBITDA ratio will come down.

Please turn to Slide 11 for an update on Bombshells expansion plans. Our four Bombshells locations in the greater Houston area continue on schedule. We are building four locations that are the same as our prototype on Highway 290. This should assure us of consistent, high-quality results. In our latest developments, construction is scheduled to start next week for our location on US 249, and we have a location in Katy under contract and awaiting our building permits to be approved. When possible, we are using bank financing to purchase Bombshells real estate and finance construction, fixtures, and furniture to enhance our cash-on-cash returns. The new units will bring the chain to ten Bombshells in operation by the middle of next year. The average Bombshells has been running a little more than $4.5 million in annual revenues, with segment operating margins around 20%. Doing the simple math, we are looking at having the Bombshells segment by the end of the next fiscal year with an estimated run rate of $40 million to $50 million. And as revenues increase, so should operating leverage, which would help expand profitability.

Our next target markets continue to be San Antonio and Miami. In case you didn't see it, we put out a news release last week announcing how Restaurant Business magazine named Bombshells to its 2018 List of Fastest Growing New Restaurant Concepts. We greatly appreciate this third-party recognition, and this is especially rewarding, since we've only open the first location five years ago.

Please turn to Slide 12 to review our capital allocation strategy. We simplified the slide down to its core tenants of our strategy. The key metric we look at is our free cash flow relative to our market cap. Based on free cash flow of $23 million and current market cap of more than $310 million, the after-tax cash flow yield on our equity is in the mid 7% range. This is what we consider to be our risk-free return by buying back our own assets in the open market. At that yield, however, we are more likely to use capital more productively for club acquisitions or to open Bombshells, as we are doing. To compensate for this added risk, our hurdle rate has to be at least 25% to 33% cash-on-cash return, unless there is a significant strategic rationale to do otherwise.

Should free cash flow rise, our stock price ease to the point where the yield is nearing that double-digit percentage range, and it exceeds the yield of accelerating payments on our highest interest debt, we would look at buying back shares again. Currently $25 is the breakpoint for these criteria. With the stock significantly above that price, we would continue to use capital to acquire or open new units. Should the stock fall below that point, we would use capital to buy back shares. We continue to apply this formula and lessons learned from the past to almost all of our decisions involving capital investment.

To wrap up, please turn to Slide 13 for a review of our three to five-year financial goals. Our objective is to grow free cash flow by more than 50% from our fiscal ‘17 level to approximately $30 million a year. On a per share basis, we'd like to grow that on an average of 10% to 15% per year. We have three strategies for achieving that. One, acquire more great clubs in the right markets. As I mentioned at the start of this call, we are currently in active negotiations with club owners in multiple markets to purchase their clubs. Two, continue to expand the number of company owned Bombshells. Our target is three per year. And third is strict adherence to our capital allocation strategy. If we can't find the right acquisitions or Bombshells locations, we will sit, wait, and let our capital build.

Now, let's open the calls for questions.

Operator
[Operator instructions.] Our first question today comes from Frank Camma from Sidoti. Please go ahead with your question.

Q: Hi, guys. Good afternoon. I was obviously pretty surprised, pleasantly, with the margins here, so couple of questions on that. First of all, are you seeing any creep —I thought you might—in commodity costs on the food side. Let's talk about that first and how you might be handling it?

Eric Langan – President and Chief Executive Officer
Actually anything that we've seen in cost increase, we've more than offset with the drop in chicken prices. I was actually just talking with David Simmons the other day about how much chicken has come down. I've read an article, I get a lot of—I've signed up to a lot of restaurant newsletters these days, and I read an article about how chicken prices come down. So, I called to ask him how it's going, and he said, "Man, it's been fantastic because wing prices have dropped so much."

Q: That makes sense because your menu is tilted towards things like chicken—wings and stuff. So, I guess that's a big component of your costs. That does make sense. Now, how about the salaries, though, I thought that would creep up, given the higher component of Bombshells. Are you seeing anything there?

Eric Langan – President and Chief Executive Officer
We've kept our costs in line. We've given some significant raises. I think the taxes are really helping offset some of that. The lower tax rates have made that much, much easier on us. I think that you're seeing that the Nightclubs segment has been fantastic for us. We're still seeing increases in service revenues. If we can continue those trends, I don't think salary and wages are an issue that we're going to have to look at. On the corporate side, we are having to—we're still watching that very closely, as the labor market tightens—corporate staffing, we're having to watch corporate staffing, pricing, and making sure that we're paying our corporate staff employees, especially in accounting and whatnot—competitive rates. But overall, I mean I think we're keeping it in line with where we've always been.

Q: Obviously, talking before you released the revenue numbers earlier, you were thinking there would be like the typical seasonal slowdown, so is it basically just the strong economy and your ability to bring in those people in the clubs, and can you talk about sort of the summer, because that typically is also like a seasonal slowdown?

Eric Langan – President and Chief Executive Officer
Yes, I mean typically we've slowed down in the third quarter and slow down literally more in the fourth quarter, but we didn't see it in the last quarter, I think, partly because the Houston Rockets—the Bombshells did very, very well, especially the Houston locations, while the Rockets were in the playoffs. We're seeing definitely the oil patch areas, Odessa and Longview, having very nice bounce backs right now. But overall, I mean, sales have been strong everywhere: Minnesota, Florida, New York, all have been pretty steady and pretty good for us. You can see that in our service revenue. Any time service revenue is up, profits are up because there is really no real associated cost with those service revenues.

Q: Okay. I think that's all I have for now. Thanks.

Eric Langan – President and Chief Executive Officer
Thank you, appreciate it.

Operator
Our next question comes from Marco Rodriguez from Stonegate Capital Partners. Please go ahead with your question.

Q: Good afternoon, guys. Thank you for taking my questions. Just wondering to kind of piggyback on that last question on the same-store sales and kind of your expectations. I know last quarter, again, you were expecting kind of the seasonal slowdown that didn't seem to happen, and so I'm kind of wondering what your thoughts are here for Q4 and same-store sales?

Eric Langan – President and Chief Executive Officer
I mean it's really hard to say on a quarter-to-quarter basis. I'm hoping that we can continue with the trend of at least 3% same-store sales, that's kind of our internal targets. That's what we're watching the year-over-year units and talking with our regional and general managers and having them target—beating their last year by at least 3%. Some of them are doing a little better, some are skating along, but we're excited about the potential. As long as the economy stays strong, I think we follow the trends until the trend doesn't work anymore. We're waiting for a trigger. If something triggers in the economy or something happens that slows peoples' spending down, we will have to adjust the model. But I think right now—I think we shoot for that 3% same-store sales growth.

Q: Gotcha, that's helpful. Then in terms of the Nightclubs segment and your comments on the kind of the M&A landscape, can you maybe talk a little bit more from a high level, just as far as how full that pipeline might be as far as potential targets, and maybe if you can talk a little bit as far as how close you might be with any potentials?

Eric Langan – President and Chief Executive Officer
Sure. I mean, putting it in simple terms, the lawyers are working on a couple of deals. As far as the pipeline itself, there are several behind the ones that the lawyers are working on that we're still off a little bit negotiating certain terms or negotiating price, or maybe we've come to terms on price but not necessarily down payment and payouts, things like that. We can probably be about as active as we want to be over the next six months. At the end of this month, or actually the 20th through the 22nd, we'll be at the Gentlemen's Club Owners Expo, where all the club owners come and meet every year in Vegas. We'll be out there for three days. I have lots of meetings set up, talking with several people out there. I expect several people that I'm not scheduled to talk to approach me, because that's typically how it works. And so, we'll look at the pipeline we have in place right now and then

look at anything new that's out there that's available that we didn't really know about and kind of get a better strategy in the early part of September, as to where we want to focus our time and where we want to move forward.

The nice thing is we have four Bombshells lined up right now, so we are looking at properties in Miami, but we've got plenty of time left on that. So, our main focus, I would say, through the end of this calendar year, through December is going to be very focused on club acquisitions. I think that's where we're—where our time is going to be best spent, and I think that's really—we're to that point, we've got enough Bombshells, like I said, lined up and ready to go, and it's time to grow the club side again. We've absorbed Scarlett's and St. Louis. Both are doing very, very well for us. We've lined up management and been training some management to move into some new markets. So we're looking at new markets, not just markets we're already in, and I think that as we—the lawyers work out the details on the ones that we've got active,—the pipeline will remain robust going forward.

Q: Gotcha. And then kind of moving on to the Bombshells and your comments on Miami, can you maybe just talk a little bit, as far as the landscape there that you're seeing, what sort of opportunities might be available, and maybe kind of where you are in terms of what ending, as far as getting close to finding some targets down there for areas to expand?

Eric Langan – President and Chief Executive Officer
Sure. In Miami, we're having a little more trouble finding properties to actually buy, so we're looking at some lease deals, which will raise our cash cost upfront, and our cash-on-cash returns will be tighter into that 25% to 33% range versus the range when we're only have to put up 25% cash on these things and owning the real estate. We do have a property or two that we're looking at—we can buy. The real estate is much more expensive down there, as we look at the larger developments, like we've done in Texas, where we're buying multiple acres, building our property, and then selling off the additional property after we've increased the value by bringing the traffic close up. So, it's a little different market for us, but we'll learn it in time. The good news is we have plenty of time, and we have some great operations in Florida currently with Tootsie's and Scarlett's. So, we'll find what we're looking for there. The nice thing is the competitors that we're looking at there and the things that we're seeing in that market, the numbers are much higher. The sales are much higher at most of the sports bar, theme-type restaurants than they are in Texas. So, that's a big plus for us.

Q: Gotcha. And last quick question, just kind of a housekeeping item, just kind of noticed here on your balance sheet, if I'm not mistaken, assets held for sale increased a couple of million dollars, sequentially. Did something else get pushed over to be sold, or was there a revaluation of some items that were already in there?

Eric Langan – President and Chief Executive Officer
I believe those are the properties we now have under contract. When we have raw land, we don't put it in assets held for sale until we have a contract on it. I think is what we're doing with our policy. So, we did get a couple of contracts on some of the raw land next to the Bombshells properties, and so, as those properties go into contracts, they are being moved into assets held for sale.

Q: Gotcha. Thanks a lot. I appreciate your time.

Operator
[Operator instructions.] Our next question comes from Darren McCammon from Cash Flow Kingdom. Please go ahead with your question.

Q: Hi, guys. Forgive me if I repeat a question. I got in a little late here—So on operating margin, you guys did quite a beat on operating margin. Should I be expecting something in the 22% range going forward, or is this—it's nice to see, but is it a one-timer, or should I be budgeting for this going forward?

Eric Langan – President and Chief Executive Officer
I was looking at the trend and it's on Slide—

Q: It's on Slide 17.

Eric Langan – President and Chief Executive Officer
I mean, if you look out of the last—six quarters—or actually last seven quarters, you've had two of them at 19%, the rest have been over 20%. I guess it's just going to pin on this—if the service revenues stay as strong as they are, the Bombshells will drag it down a little bit, as more of the revenue comes from Bombshells, but the Bombshells are continuing to increase, as well, so as they move up into the plus 19%, I mean—it's hard to say, we're just going to have to watch it over the next few quarters and see how it develops. But as of right now, I think we're pretty much in line with where we've been through the last three quarters in a row now, it would—I guess we have 25, 23, 22—so I'm hoping we see—we're definitely where we want to be.

Q: I keep budgeting for it to drop a little bit, as you open Bombshells, but it's just not happening. So, good to see.

Eric Langan – President and Chief Executive Officer
Well, the nice thing about the Pearland Bombshells is it was very big opening for us, highest gross revenues that a Bombshells has ever done.

Q: What is the run rate on Pearland now?

Eric Langan – President and Chief Executive Officer
I don't know where we're currently at; July has been a very, very rough month for us. I don't know if you're probably aware but at 100 degrees plus for 20-some days out of the 30-some days, our patios are having a lot of slowdown, but we're looking very forward to football season starting. I think some of the first pre-season games are tonight, so that's going to be a pick up for Bombshells. And one of the other things we're doing is, since we have several new stores opening, we've just done some negotiations and landed some sponsorship spots on all the sports radio stations in Houston and a couple of the other larger rock stations and whatnot and one of the hip-hop stations. We're buying sponsorship for the Astros, the Texans, the Rockets, and lining those up, and I think we're even doing some stuff with the soccer team.

So, we're going to start doing some marketing, especially in the Houston market where we haven't really done much marketing. So, I think that we'll see a nice increase in the sales trends and Bombshells from that. It's new, we'll see, let's see how this next quarter comes out, and then, as we open up the new store in September, that's going to help give us an idea where those Bombshells are going. As we have open eight stores in the same market, we're going to get to see what kind of market saturation and crossover we get with the branding. I think we're going to see some nice increases in margins because of that. So, I'm hoping to push those Bombshells. I know our top stores are running margins in the 26%, 28% range.

So, if we can continue to push that up, I think the Bombshells can average in the 20s. If the Bombshells average in the 20s and the clubs stay where they are at, especially as we close these underperforming clubs like Philadelphia, a small club in Houston, as those margins, I call those margins the anchors pulling the margins down, as those margin numbers go away, we're going to see a higher increase in the margins for the clubs as well. So, I think maybe we'll stay in these operating margins in the mid-20s or lower 20s.

Q: Just bit of irony calling 20% plus margins anchors, but okay.

Eric Langan – President and Chief Executive Officer

Well, no, those were the ones—I'm saying they are being anchored down at 20%, right. We have a club that has a lower or 4% margin that's pulling the other ones down.

Q: I know a lot of restaurants that would love to be anywhere near that. So, how are you going to measure the effect of the advertising, the sports radio, and stuff?

Eric Langan – President and Chief Executive Officer
Some of the stores have been open for three or four years in Houston market now, and so we're going to be able to see where they're at and what their trends have been, and kind of watch. The nice thing is when you—it wasn't extremely expensive for us, and when you divide it by four stores, it's a little more expensive, but by June, we'll be dividing it over eight stores, so it gets really, really inexpensive on a per store basis to do these things.

Q: So, you think you've got to buy store data by day to be able to tell whether or not radio spots help or not?

Eric Langan – President and Chief Executive Officer
I don't think we're going to tell it by day, but I think we'll be able to tell by month, by quarter, and especially on the year-over-year and just seeing new faces, right? If we're—obviously, if we're seeing new faces, then the radio is working for us, because that's the idea to help build the brand to bring in new faces into the business. And I think we'll be able to see if that's working for us. Along with the radio, we're getting internet spots with them, we're getting live remotes, and it's actually a very nice buy package that we've been able to negotiate on this.

Q: So, you did almost $8 million in free cash flow, but your actual cash went up less than $1 million. Where did the difference go?

Eric Langan – President and Chief Executive Officer
Well, a lot of it's going to the Bombshells properties, we have to put 25% down—we have to put the first 25% of construction down with, actually, three construction sites going right now, that's a considerable amount of cash that's gone out for that. So, I think that's where the majority of it's going.

Q: Did you have to pay back any Scarlett's or pay down any loans or anything?

Eric Langan – President and Chief Executive Officer
I think we—was that $2 million pay down in Scarlett's this quarter or last quarter? Phil, do you know when that was paid down?

Phil Marshall - CFO
It was the last quarter.

Eric Langan – President and Chief Executive Officer
That was the last quarter, that's what I thought.

Q: Okay. I'll see it when the Q comes out. Some comments on your slides: the rollout slide that you added, I think that's new this quarter. That's really helpful, I like that, might be the first time I've seen it. And then also—well, I've always loved the capital allocation slide but I just wanted to comment, you can't make it any plainer than that. Below 25 we buy shares and above that we do this. So, good job on that.

Eric Langan – President and Chief Executive Officer
This time it's just to simplify it up. It was getting a little cluttered with all the little boxes and all the little target things on it, so I decided let's simplify that up, and just put it in plain English. If the stock's below this, we're going to buy stock, and if the stock's above this, we're going to keep growing.

Q: Well, when you make it that plain, I don't think you're ever going to be buying stock. In other words, people will buy in front of you, which is not the best thing.

Eric Langan – President and Chief Executive Officer
We're going to keep buying clubs, I mean, that's the nice thing is we're in that position today and that's—we've worked hard to get here. And the discipline, I think, is really paying off for us and for the shareholders.

Q: Agreed. The four Bombshells that are coming up, I know in Miami, you're looking to lease. Are the rest of them going to be purchases?

Eric Langan – President and Chief Executive Officer
These are all four purchases. We'll own the real estate and build the building on all four of these. In fact, we're—a couple of them are—the I-10 site is a development site. We bought a little over eight acres and put in the sewage and retention. We bought the land extremely cheap, and we've already sold off—we've turned it into three pad sites. We've built on the middle pad site. We sold the east path site and the west pad site. We have—it's listed with brokers, and we have several interested parties looking at that now. Hope to have that under contract before the end of the fourth quarter.

The Pearland pad sites. The business is open now. I'm talking with a couple of different developers right now on what we want to do with those two pad sites or whether we just want to list them and just let anybody move on them. We're trying to control who is next to us and put in businesses that compliment or add business to our Bombshells. The 249 site we've already sold. We've already sold a 1.59 acre site there. That will be a Corky's Barbecue out of Memphis. That will be one of their first Houston locations to open as they move into Texas. We think that will be a complimentary restaurant that will help our business. And we are currently looking—we're talking with several other concepts on the remaining—I think we have about 7.3 acres left there that we're going to sell off.

Q: So, that's sounds like it's becoming another strategy of yours, buying larger chunks of land and almost having a real estate aspect more and more to the company, real estate development.

Eric Langan – President and Chief Executive Officer
Only because it made so much sense for us. To do it in other markets, we're not really looking to—the pad sites we're looking at in Miami, for example, are 2.2, 2.4 acre already build pad sites, the Katy pad site was a super lot ready-to-build path site, where somebody else did all the development. We pay a little bit more that way, but I think we've proven the concept enough now that we're—this was really a way to limit risk for us, I think we've—we're proving the concept out; we kind of know our demographics. We know what we're doing when we open these things. And, so I'm not looking to do that as much, and we just kind of got into these. The 59 location, we had to buy four acres. We're building a 20,000 square foot shopping center on it. Once it's built and leased out, we'll probably sell the shopping center off with a parking easement.

Q: Okay. So, what I heard, that's not really a long-term strategy, it's just how it worked out in Houston, is that correct?

Eric Langan – President and Chief Executive Officer
Yes. Correct.

Q: Okay, that's all I have. Thank you, guys. Good quarter.

Operator

Our next question comes from Steven Martin from Slater. Please go ahead with your question.

Q: Yes, thanks for taking my question. Eric, you did $20.6 million of free cash flow for nine months. Your guidance was $23 million for the full year, and you said you were going to exceed it. But frankly, that would—you had a great fourth quarter last year, and now, to get to your guidance, you only have to do $2.4 million of free cash flow.

Eric Langan – President and Chief Executive Officer
Well, we don't want to call it guidance. It's our target. We targeted at the beginning of the year to do $23 million in free cash flow, and to think we'd only do $2.4 million would be extremely low for us. So, that's why we said we will exceed that target. We're not raising the target or doing anything with that target. We'll issue our new target for '19 and in the December year-end.

Q: Okay, and the Scarlett's acquisition you did last year in Florida, can you comment on how that has done since you bought it?

Eric Langan – President and Chief Executive Officer
It's doing very well for us. We're in line with the projections that we thought we would be able to—the increases that we thought we'd be able to increase it. It is moving in the same-store sales on a go-forward basis, so our—I think that will definitely help with our same-store sales percentages, which is why I say we're targeting 3%. And we're very happy with it. If we can find two or three more of them, we're ready to buy them.

Q: Okay. Within the corporate expense, you've had a whole bunch of one-time items the last couple of quarters. When should we see those start to diminish, the lawsuit settlements and some of the other items?

Eric Langan – President and Chief Executive Officer
We've moved through most of those. In fact, I was just looking at what we have left from uninsured. There's only two or three cases left, I think, of the uninsured cases. Unfortunately, we see new stuff from time to time, but, overall, it's gotten better. Part of that one time stuff was the New York State sales tax audit that we were going through. That's all settled now. So, we know those numbers. Those are expensed out. There is not a lot left out there, I hope—I mean, you know, the problem is it's unforeseen, so if I could predict it all would be great, because then we could just plan for it, but, overall, I think we're—it's lower and lower each year, I think that's the good news, it's getting lower and lower each year, there is still some of them popping up, but it's getting lower and lower.

Q: All right. Thank you.

Operator
Our next question comes from Bob Brown, private investor. Please go ahead with your question.

Q: Thank you. Two questions—great year, so far. Now that you—I think you made a comment likely the last quarter in the—one of the releases saying how you feel like you really gotten a good handle on all aspects of opening up the Bombshells in terms of picking the real estate, the legal, the business side, and given that we're going to be—we're looking at ten and not too long away—not too far away, what do you think—are we getting close to where we think franchising is going to be a more realistic target here?

Eric Langan – President and Chief Executive Officer
Yes, we are getting people, we are getting calls again, which is—we hadn't in a long time. We're not even marketing for calls, so it is—we're getting some calls, we're talking to some people—same as always, we're looking for—our first franchisee is going to have to be a larger operator, someone who knows what they are

doing. We don't want to have a location opened and closed somewhere or anything like that. So, it is a major investment. It's not a $300,000 investment. It's a $3 million plus investment to open one. I'm hoping so—I think when we get to that $50 million mark, I was looking—I've kind of looked up some of the past—smaller chain restaurants that opened up some company stores and then seeing when their franchising really blew up, and most of them we started seeing at 10 to 15 locations and $50 million plus in revenue.

So, I think we reached that by the end of this year—I'm sorry, in fiscal '19. And I think at that point maybe we will look at hiring a franchise sales person again in marketing and advertising franchises, again. I just don't think in the next 12 months it's going to make a lot of sense for us. I think the next 12 months we—first of all, we and management are focused on the club acquisitions because there is several out there. We're working hard on them. We have the Bombshells openings lined up. I know the Bombshells team is going to be very busy opening these four locations. I mean, technically we're opening four locations between September 30th of this year and June 30th. So really while we keep saying here that's really only a nine month period or actually about a seven month period that we're going to be opening these next four stores. So, they're going to be very busy with that. So, if something—if the right person comes along, we'll take the time and energy to make it happen, but it's not something we're actually actively out searching for franchisees right now.

Q: Okay. And second question, I just happen to see this on the news items today, I assume you guys did as well, with Buffalo Wild Wings. Anything in terms of possibilities of doing some sports betting now, and now that it's legal and [indiscernible] anyway in terms of some of the Bombshells location?

<u>Eric Langan – President and Chief Executive Officer</u>
I don't think sports betting is legal in any of our markets. If it became legal in our markets, we'd look at it. We are looking at some EA Sports stuff, and we're also looking at some of the fantasy team stuff, which, again, is kind of sports betting but not necessarily direct sports betting. We have been talking with some—with a couple of different groups to start like the Bombshells Fantasy Sports League or something along those lines, where we do a revenue share with someone else's platforms. That is something we could be looking at for additional revenue at some point in the future.

Q: Okay, great. Thank you.

<u>Operator</u>
[Operator instructions.] Our next question comes from Ishfaque Faruk from WestPark Capital. Please go ahead with your question.

Q: Hi. Good afternoon, guys. A couple of questions from me. Somebody already asked regarding your M&A targets. Do you have a sense for the size of the M&A target? Is it going to be like Scarlett's Cabaret or is it going to be like some of the smaller ones, like the $1 million or $2 million one you did recently? And the geographical extent?

<u>Eric Langan – President and Chief Executive Officer</u>
The active ones we're looking at now are in the $10 million to $20 million range in terms of cost of acquisition for both the club and the real estate.

Q: And which geographies are you're looking at, primarily?

<u>Eric Langan – President and Chief Executive Officer</u>
We are not disclosing that at this time. If I talk about which markets, it's too easy to figure out which acquisitions we're looking at.

Q: Okay, I understand that. Okay. Another one was your long-term debt. Are you comfortable with your debt creeping up? I know you've commented and also mentioned it on your slides that you're up. Your debt grew to almost $133 million or so, and there is a lot of high interest rate debt in there too. Are you comfortable with that, even though the company's margins are growing as well?

Eric Langan – President and Chief Executive Officer
We don't have a lot of high interest rates in there. Most of that is associated with the acquisition of Scarlett's, and so, we're not worried about that debt at all. Scarlett's is performing as expected. It was a 100% financed acquisition. If you will remember, we basically bet none of the company's money. We borrowed the down payment. We financed the rest with the owners. We slowly started taking out some of that with a $2 million payment to owners. The $5.4 million balloons in 2020. We'll have to decide how we're going to move that debt. $90 million of our debt is associated real estate, which is financed at very, very low rates, average rate is 5.62%. So we're not worried about the real estate debt. As we sell off some of the non-income producing properties and the land around the Bombshells, that's going to drop our debt significantly.

The biggest thing in 14 months our debt service level goes down by $3 million a year when we don't have to continue to make the extra $250,000 monthly principal payment on the Centennial Bank refinance of most of our property. So, no, there is no worries at all on the debt level. It's well below our three times EBITDA, and our EBITDA is expanding, as well. You have to remember, when the four Bombshells open, that's going to grow or EBITDA considerably, and the debt associated with those Bombshells is included in here already.

Q: Yes, okay. And sticking to Bombshells—the margins of Bombshells went up a lot this quarter. Is it just scale operating leverage; is there anything more to read into that?

Eric Langan – President and Chief Executive Officer
Well, you've got to figure—your oversight management is being divided by more and more revenue, right, so as the percentage of revenue, the oversight management costs are going down. We're getting more buying power, so we're able to negotiate better pricing. That's helping. And the stores we're opening are doing larger volume and the same-store sales of the Bombshells are increasing, as well. So, that's all helping expand the margin. So, as we open up the next four stores, I'm hoping that we'll see those margins at running around 20%. There is not a lot more margin increase but, obviously, a little. I think we're still about 19%, I think, on Bombshells, so we'll get another point or two out of it, we'll be very happy.

Q: Wonderful. Thank you, very much. Wonderful quarter.

Operator
And ladies and gentlemen, at this point we'll take any final questions. Once again, this will be the last chance for questions. And ladies and gentlemen, at this time I'm showing no additional questions. I'd like to turn the floor back over to Gary Fishman for any closing remarks.

Gary Fishman – Investor Relations
Thank you, operator. We've included a couple of supplemental slides in our appendix. We have our calendar in there, a few things coming up. If you joined the call late, we're having a meet management at Rick's Cabaret in New York tonight from six to eight o'clock. Rick's Cabaret is at 50 West 33rd Street between Fifth and Broadway, if you haven't RSVP-ed, ask for me at the door. August is the 20th anniversary of the acquisition and merger with the Taurus Entertainment Company. August 19th to 22nd, as Eric talked about earlier, is our Annual Gentleman's Club Expo in Las Vegas, this is the adult nightclub industry's national convention trade show and awards. Now, the following week, on August 29th, we're holding our annual meeting at corporate headquarters in Houston, and on October 9th, we'll be reporting our fourth quarter Nightclubs and Bombshells sales.

On behalf of Eric, the company, and our subsidiaries, thank you, and good night. And, as always, please visit one of our clubs or restaurants. Thank you.