Transcript of RCI Hospitality Holdings, Inc.
Fourth Quarter 2018 Earnings Call and Webcast
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Participants
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Eric Langan – President and CEO

Analysts
Frank Camma – Sidoti & Company
Jason Kolbert – Dawson James
Darren McCammon – Cash Flow Kingdom
Doug Weiss – DSW Investments
Peter Siris – Private Investor
Joe Wang – Private Investor

Presentation

Operator
Greetings, and welcome to RCI Hospitality Holdings Fiscal 2018 Fourth Quarter and Year-end Conference Call and Webcast. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. [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. Please go ahead.

Gary Fishman – Investor Relations
Thank you, Hector. For those of you listening to this call on the phone, you can find our conference call presentation on the RCI website. Click company and investor information just under the RCI logo. That will take you to the company and investor info page. Scroll down a little and you'll find all the necessary links for the fourth 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 and we disclaim any obligation to update information disclosed on this call as a result of developments that occur afterward.

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

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

Eric Langan – President and CEO
Thank you for joining us, everyone.

Please turn to slide 4. We are pleased to report that after the market closed today we timely filed our 10-K and reported our fourth quarter and year-end results. Fourth quarter results were good for this time of the year. Total revenues were $40.7 million. That's up nearly 4% year-over-year. There was a loss of $0.27 per share, slightly higher than last year, due to $5.5 million pre-tax in other charges, most of which were non-cash.

On a non-GAAP basis EPS was $0.41. That's up close to 14% year-over-year. Free cash flow for the year totaled more than $23 million in line with expectations. That was up more than 20% year-over-year.

Looking ahead in Fiscal 2019 we expect to benefit from the Chicago and Pittsburgh nightclub acquisitions, new Bombshells locations in the Houston area, the sale or lease of several remaining non-income producing properties, and same-store sales growth. As we announced earlier this month, our initial 2019 fiscal free cash flow target is $26 million. This represents a 13% year-over-year increase from our original Fiscal '18 target and is consistent with our corporate goals.

Please turn to slide 5. Sales benefited from a strong 6.1% year-over-year increase in Nightclubs comparable same-store sales. Bombshells' sales were virtually level year-over-year as new units offset a decline in same-store sales due to a number of quarter specific events that we previously disclosed. While a small contributor, other segments increased nicely. This reflected the revitalization of the Robust energy drink business under our management. We also had very strong revenues from our Gentlemen's Club Expo in August in Las Vegas.

Operating income was up a little. Improved sales and margins in Nightclub and the Other segment more than offset lower Bombshells operating profit. other charges, and $1 million in state sales tax settlements. On a non-GAAP basis, which excludes other charges, we were down a little bit. That was entirely due to the sales tax settlement, which we do not include from non-GAAP calculations.

Please turn to slide 6 for a discussion of items that affected fourth quarter results. Other charges reflected $3.8 million in non-cash impairment and other charges in the Nightclubs segment. This was due to slightly lower sales at three clubs in Texas and our plan to sell or lease the former Foxy's Dallas location. Other charges also reflected $1.4 million in non-cash impairments and other charges in the Bombshells segment. This relates to the Austin location and the cancelled Willowbrook location. We are considering some changes to improve performance in Austin, and Willowbrook was where we had the conflict in 2015 with the landlord which halted development of this location.

We had three state sales tax settlements. New York was the largest at more than $800,000. What we encountered in 2018 was a retroactive application of sales tax to dance dollars for multiple years. Under a long-standing interpretation of the law, we did not believe the collection of these taxes was required. But rather than engage in a drawn out court fight, we opted to settle as it is likely cheaper for us in the long run. The amount is not excluded from non-GAAP calculations because sales tax audits have become fairly routine. However, we don't expect to see recurring amounts anywhere near what we saw in the fourth quarter.

You should also note our effective tax rates for the year and the fourth quarter. For the year it was a benefit of 16.7%. This included $8.8 million in the final calculation of the reduction in deferred tax liability as a result of the federal tax reform. However, this resulted in a tax increase in the fourth quarter to adjust for the year. On the non-GAAP basis, we used 24.5% effective tax rate. Conversely, this resulted in a fourth quarter income tax reduction to adjust for the year.

Please turn to slide 7. The fourth quarter is typically our seasonally weakest quarter. Having said that, fourth quarter revenues were a record for the period, our fourth highest quarter ever and the tenth quarter in a row with same-store sales growth. As for margins, had the sales tax settlements from our non-GAAP calculations been excluded, operating margins would have been 30 basis points ahead of a year ago quarter.

Please turn to slide 8. Fourth quarter adjusted EBITDA came in at $9 million. For the year it was more than $44 million, up close to 19% compared to Fiscal '17. Cash on hand at September 30th was close to $18 million, up 35% from June 30th and up 79% from a year ago. Year-end cash included bank and other debt rates in anticipation of the Chicago and Pittsburgh acquisitions in November. As a result, free cash flow for the year totaled $23.2 million, exceeding our original target. This enabled us to achieve a free cash flow compounded growth rate of 16% since Fiscal 2015, slightly ahead of our corporate objectives.

Please turn to slide 9. I'd like to take a minute to review some recent developments. During the fourth quarter, we borrowed $3 million from banks to buy out our partner in the Club Onyx real estate in Philadelphia and to finance Bombshells expansion in Houston. We also borrowed close to $8 million from banks and third parties to help fund the cash portion of the Pittsburgh and Chicago acquisitions. I'd like to note that this was our first unsecured bank loan.

In October we sold the Philadelphia club business for $1 million and signed a 10-year triple net lease to rent out the real estate to the new club's owners. In November we closed on Pittsburgh and Chicago acquisitions. Combined, we expect them to generate more than $5 million in EBITDA and a cash-on-cash return of 33% and 40%, respectively. This in line with our corporate objectives for acquisitions and better. Approximately two weeks ago we opened a Bombshells on I-10 East in Houston. This is our seventh restaurant in the chain and the fifth in the Houston area.

Please turn to slide 10 for a review of our debt. Since June 30th, total debt increased $10 million while our average weighted interest rate remained relatively flat. Real estate debt increased a net $4 million from the new real estate I just mentioned plus some construction draws on existing Bombshells construction. Parent level debt increased a net $6 million from raised funds used subsequent to the quarter to acquire the real estate related to the Chicago and Pittsburgh clubs. All other slices of debt declined.

Please turn to slide 11. While slightly higher, debt continues to be manageable. I'd like to point out Fiscal '19 amortizations include our $5 million bank line of credit installment loan that will be paid off by the end of April. We also moved the $3 million Scarlett's balloon in 2019 to 2020 after the end of the September quarter and the $1.5 million realty balloon in 2019 will become part of the new construction loan for the Katy Bombshells before it is due.

I'd also like to note that by year-end Fiscal '19, we should be 65% or less loan-to-value on our large Centennial real estate loan. At that point, amortization will drop $250,000 a month, freeing up $3 million on an annualized basis. Occupancy costs—one of our largest areas of expense—continued to decline. They dropped to 7.8% in the fourth quarter and 7.7% for the year.

Our ratio of total debt to trailing 12-month adjusted EBITDA increased to 3.17 from 2.95 at June 30th. We like to keep this ratio below three times. The increase was due solely to lining up borrowings in anticipation of the Chicago and Pittsburgh acquisitions. In the quarters ahead, we should see this ratio decline.

Please turn to slide 12. I'd like to give a little update on the first quarter of Fiscal '19. Total sales and same-store sales for Nightclubs were up in October and November compared to a year ago. Both the Chicago and Pittsburgh acquisitions are performing right in line with expectations. In early calendar 2019 we plan to rebrand both clubs as Rick's Cabaret. We are also working with potential tenants on the two clubs we closed in Dallas earlier this year, Foxy's and Onyx. We hope to have both properties in addition to Philly earning income for us very soon.

Bombshells total sales for the first two months of the first quarter of '19 are ahead of the first two months of fourth quarter of '18. Year-over-year same stores sales will be challenging because a year ago quarter benefited big time from the Houston Astros. Last year the Astros won the World Series. This year they played significantly fewer post-season games.

The new Bombshells sales are great for the first week. A delay in opening was due to rain which affected construction and then the scheduling of final inspections. We have updated the schedule for the three Bombshells in development. US 249 should open in February. Katy's location will open in April or May, and the US 59 location will open in May or June. There could be a swing of a month or two here or there due to factors beyond our control.

Please turn to slide 13 for our capital allocation strategy. Since our last call, we have updated this slide to show free cash flow yields based on our initial Fiscal '19 target of $26 million. As you know, our strategy calls for repurchasing of shares in open market if the yields on our free cash flow rate relative to our market cap exceeds double-digits. With the free cash flow rate of $26 million, that means we are a buyer at $27 a share or less.

Please turn to slide 14 where I'll discuss more about capital allocation in the context of our financial goals. We also simplified this slide. As stated previously, our objective is to grow cash flow at 10% to 15% per share annually through three strategies. Right now we are focused on using as much accessible free cash flow to buy back stock at these prices based on our capital allocation strategy given our current stock price where we can get what we consider to be risk-free after tax free cash flow yield of more than 13%. We are definitely more inclined to buy back stock rather than to take on additional risks buying new clubs or opening new restaurants.

Having said that, I believe this is a unique time in the gentlemen's club industry. So we will still be actively looking at acquisitions when and where appropriate assuming they meet our corporate objectives for M&A.

We are also focused on finishing our cleanup effort involving under-performing clubs this year. As you know, we have closed a number of locations over the last few years in line with our capital allocation strategy which calls for being more aggressive in refurbishing, selling or leasing properties that are not providing adequate return. We have pretty much divested all under-performing operations. Now and in the next quarter or so, any remaining non-income producing locations should be leased, sold or under contract to be sold.

As for Bombshells, we will complete the three locations in development giving us a total of ten locations. Then we intend to spend time to assess where we are. We want to ensure they are working very well. We want to look at the market and growth trends and we want to gauge the return on our strategy of owning and developing the real estate ourselves.

As for our stock price, while we are not happy it is this cheap, we believe the price will reward long-term holders as we buy shares when it's yielding over 10% or expand when it's not following our capital allocation strategy.

To keep open the lines of communication, we will hold a conference call Thursday, January 10th to discuss the first quarter sales figures we'll be releasing earlier that day. We'll also be available to answer questions for anyone who missed this call due to such short notice. Thanks to all our concerned investors for supporting us and for the advice during this period. It is truly appreciated.

Operator, let's start the Q&A.

Operator
Thank you. At this time we will be conducting a question-and-answer session. [Operator instructions]. One moment please while we poll for questions. Our first question comes from the line of Frank Camma with Sidoti. Please proceed with your question.

Q: Hi, guys. Good afternoon. Happy New Year's Eve.

Eric Langan – President and CEO
Happy New Year, Frank.

Q: Obviously the revenue that you already reported wasn't surprising or anything and you gave a lot of detail before on the weakness in Bombshells which it's pretty clear that you're not happy with. What's interesting when you look at the margins here given the fact of what's the same-store sales decline is your costs of goods sold was actually good year-over-year when you look at it on a percentage of revenue, which I wouldn't have expected. You actually picked up about 60 basis points. So the question is, how were you able to manage costs in the scenario where you essentially had fairly sharp decline in the restaurant business which typically you would find negative operating leverage, if you will?

Eric Langan – President and CEO
Yes. Obviously we're able to control kitchen staffing and stuff like that to help keep those costs in line. One of the biggest costs that affected margin was some of the legal bills associated with Fuqua as well. So I think this quarter, the October/November/December quarter is going to be a quarter when we're going to get a pretty good look at how those trends are going to play out moving forward.

Then I think like in March I'm hoping with March Madness that's kind of the first what I would call a big catalyst to really boost everything over a long period of time. Both the Cowboys and the Texans have made the playoffs, so let's root for them next Saturday and hope that they can keep their playoff alive, because that definitely helps Bombshells considerably. We've had a really big weekend this weekend and we're looking forward to moving towards Super Bowl and hopefully that will give us a good start. But I definitely think that once we get into March Madness, it's definitely going to help Bombshells a lot, plus the warmer weather will bring our patios back.

I know our team is working on lots of different type of bike rides and car shows and things like that to really help pick up in the spring and hopefully that will get us back to where we were before we had some of these unfortunate incidents and the freeway construction should be done on 290 as well. We'll get a couple of these other locations open which gives us more exposure in the market and I think we're going to see the Bombshells right back where we want them.

Q: I guess a follow up to that, have you seen a shift at all in the percentage of revenue at Bombshells as far as—I haven't gotten to the details yet—on how much is alcohol versus food, etc.? Because it would indicate you haven't, like you're still getting good margins there.

Eric Langan – President and CEO
We're still doing a decent amount of alcohol, not what we were, but it seems like some of the food slowed down a little bit too, so you're kind of getting a very similar mix.

Q: Okay. And when do patios open up in Houston just out of curiosity from a weather standpoint? Like very early spring or late winter? When can you actually sit outside?

Eric Langan – President and CEO
They're open sometimes right now. It was in the 70s and 80s last week in Houston, so it just depends. This week it gets cold a couple days. It gets warm a couple days. So we're still getting some use, but what you really want is that all-day. At night time it still cools off and we have to maybe close a couple of the doors. We need to get to that point and I'm hoping that we're there by mid-March.

Technically is you have a few really cold weeks in February typically and then it starts warming back up and gets pretty normal, but it can extend into March sometimes. So I'm hoping this year that we get a pretty nice spring and get started early. But I think March Madness, all those college games, will make a big difference as well. They always do.

Q: Moving on to the Nightclubs, I know you're rebranding or maybe you have already done it—the two that you acquired to Rick's with I guess a more premium name. I know you extended the hours, correct? Is that for both or for just one?

Eric Langan – President and CEO
Just for Chicago, yes. Pittsburgh has regular early hours, so basically just the Chicago. We have extended the Chicago hours at this point opening at 4 p.m. instead of 7 p.m.

Q: Does that allow you to do anything on pricing or is pricing pretty much in a short-term an unchanged type of event?

Eric Langan – President and CEO
It's pretty unchanged. We're doing a little Happy Hour. You're only allowed a certain amount of hours of Happy Hour in the State of Illinois where you can discount pricing. So basically it allows us 15 hours of discounting pricing Monday through Friday from 4 to 7 p.m. to start bringing people in. But what it really does is by 7/8 o'clock people start coming in, there's already a flow going. There's already a party going. When you open at 7 p.m., everything's just getting started so maybe the party isn't really going until 9:30/10:00. So we're hoping with that little Happy Hour push that we can basically pick up those early hours. It's been working very well for us so far. So we're excited about it. Both will rebrand. Right now the signs still have the original names up. I think our new signs and rebranding other than print stuff that we've done in the club to get people used to the name change before it happens; it will all happen in mid-January.

Q: You gave a lot of details from an EBITDA and a financing basis on the two clubs. Is there a way you could just give us like approximate what the LTM or projected either/or annual revenue of these clubs are either separate or combined?

Eric Langan – President and CEO
Yes, basically between $10 million and $11 million combined. We're looking to do between $100,000 to $110,000 a week per location.

Q: As of today I assume the margins, are they lower than your base business so those EBITDA margins you get over time?

Eric Langan – President and CEO
It's so early it's really hard for me to tell. December is the first full month and today is going to be the last of that month. Basically all I have seen so far are some parts of financials from November. I just don't have an update at this time. Maybe on the January 10th call I'll have some better information for you if we can get the Pittsburgh December numbers finalized by then.

Q: Like you said, really the reason why you're hosting that call January 10th is the short notice of this call, right?

Eric Langan – President and CEO
Yes. I can tell you right now we're about half the number of callers we normally have on this call. I can see right now and it is New Year's Eve. So I want people to have time to really time to dissect. I'm sure people have plans and stuff so I want people to be able to dissect the K and get to questions. Plus I just think that this is going to be

a significant revenue quarter because of the new locations. So I will have more information for you on those locations, but I just don't have it available to me today. So we've really been working non-stop through Christmas Eve, through every weekend, getting this K done.

Q: Okay. Thanks, guys. Appreciate it.

Eric Langan – President and CEO
Thank you.

Operator
Our next question comes from the line of Jason Kolbert with Dawson James. Please proceed with your question.

Q: Another great quarter. I just wanted to ask a couple of questions in understanding the growth aspect. I think you kind of answered it around Houston versus Chicago, Philly and Pittsburgh and what impact does rising interest rates have when you look at how to arbitrage your free cash flow versus your debt? Thanks.

Eric Langan – President and CEO
Interest rates for us have declined. While they're starting to head back up, we just got bank financing less than two years ago. We did our first big note with Centennial. We had done a couple of small notes with them before that, but most of our financing was from individuals. So it's not going to have much effect for us because we basically lock our rates in five-year increments. We'll get slight increases here or there or maybe if the interest rates continue to go up, but I don't think it's going to have any real long-term effect for us. All of our short-term borrowing that we do from individuals has typically been around 12% anyway. So I don't think we're going to have to raise those rates anytime soon. And hopefully we'll start actually paying a lot of that down as we move forward, so it shouldn't have too much effect on us.

Q: In the first quarter call coming up I hope you'll spend a little bit more time kind of going through the difference between how we should be modeling Bombshells versus the gentlemen's clubs in terms of just understanding the margins of the dynamics that drive those businesses.

Eric Langan – President and CEO
We can work on that. Our biggest problem right now is we just don't have enough data to see. So I think we're going to get there by March, when we get the January/February/March quarter in, so I think we'll have a lot better idea in that quarter. We get some idea. We know that we're starting to see the rebound. So the question is do we rebound all the way back or do we rebound where we actually start getting same-store sales growth over where we were prior to the incidents that we have and the freeway closure. And those are the kind of things we're really unsure of for Bombshells at this time. That's the important thing for us.

Q: Yes. Thank you. Happy New Year.

Eric Langan – President and CEO
Thank you. Happy New Year.

Operator
Our next question comes from the line of Darren McCammon with Cash Flow Kingdom. Please proceed with your question.

Q: Hi, guys. Happy New Year's Eve to you.

Eric Langan – President and CEO

Happy New Year.

Q: What caused the delay in reporting and having to announce on New Year's and what can you do differently next year?

Eric Langan – President and CEO
The main cause is obviously we put in a new ERP system in last October and so there was a massive amount of work to be done through the audits because of all the new systems, all these separation of duties, issues that we had last year with the new software and getting through all of those checks and rechecks to make sure that all the numbers were solid, that there were no errors. It was just a really intense audit to say the least. We really had to pound it out to get filed by December 31st and I'm happy to say that between our staff and BDO's staff we were able to get that done.

Q: Well the numbers show that you did pretty well, so I guess I don't need to worry about that. Have you ever considered like picking a different time to close so you can skip the holidays in case there's an issue?

Eric Langan – President and CEO
Normally we're supposed to be filed by the 14th so we would have skipped the holidays. And tax season because if you start going into January, now you're not filing until April. So now you're going to be in tax season. So I think we had a pretty good quarter. This is really a slow time for most auditors at this point. I think it's just the new system and we were still new to BDO. You have to work together and like I said, it's just a very, very big undertaking when you talk about a full accounting software change like we have done.

If you think about it the ERP systems took us almost two full years to implement. We really started implementing this ERP system in early '16. We went live at the end of '17 basically which for Fiscal '18 it was a big ordeal. But the new system is fantastic. You talk about being able to turn data and get things done. Under the old system with what we'd have gone through we'd have filed in February or March again. It would have been crazy. Luckily with the new system we're able to really do things much better. All the invoices are sorted in the system. The recall of this system is phenomenal.

Q: I had kind of a short lead time here. I haven't had a chance to look at your cash flow. Did you buy back any shares? And if not, why not considering your capital allocation?

Eric Langan – President and CEO
We bought back a few shares in November when the stock went below $25 and then we got busy with the 10-K and everything. Going into December we thought we were going to get filed and we started tying things up, having to do final audit prep stuff. So we got busy and weren't very active in December at all. But now we have the K filed, we don't like to buy right around filing time and then once we didn't file on the 14th we didn't want to start buying before the end of the month. So we waited to get the K out. Now the K's out, we will be back in the marketplace I'm sure with whatever excess free cash flow we can spare to buy back shares at these prices.

Q: That's actually my next question. I think you said you closed September with $17 million cash on hand. What's that figure now or approximately and how much of that would you consider using?

Eric Langan – President and CEO
We used a considerable amount of that for the acquisitions in Pittsburgh and Chicago. We typically carry around $8 million cash on hand that we like to have as kind of a minimum. So when we're over those numbers and our needs for that cash isn't needed, we'll be buying back stock. We currently are over $8 million right now. I don't know the exact number at this point at the end of the quarter. And like I said, we have been focused on the K more than really cash on hand or anything like that.

Q: In the past there's been a question about your relationship with Tannos Construction. Can you outline that for us just real quick?

Eric Langan – President and CEO
Tannos Construction is a contractor that does some contracting work for us. I have made investments in some of his projects personally, some shopping centers in Friendswood, Texas, where RCI has no business or no--we don't do anything in Friendswood, Texas basically. It's a small bedroom community in Houston and I have made some investments with them, but that's about the end of it. Other than that there's nothing to tell.

Q: So just to be clear, you have never owned any property that was sold to RCI?

Eric Langan – President and CEO
No. If I'd had they'd be disclosed. Are you kidding? They look at every related party transaction 50 times. Trust me.

Q: Thanks for that and sorry to have to ask it.

Eric Langan – President and CEO
Yes. No problem.

Q: You indicated a target of $26 million in free cash flow after maintenance costs. Is that meant as a current run rate or is that the 2019 target? I guess what I'm asking is does it include the free cash flow from the two nightclubs and does it include that $3 million of additional cash flow amortization free up? Or how is that factored in there?

Eric Langan – President and CEO
It includes everything that's in our conservative estimates for what we believe we will do as of the beginning of December when we put this out. Could we do better? Sure, just don't have enough data at this point to say yes I think we'll do more. I don't think we'll do less. This is a number that like last year we said $23 million at the beginning of the year. We said look, we believe that we'll come in at $23 million. Even if no matter what else happens throughout the year, we'll hit $23 million. We have done that. That's our number for '19 at this point.

In the past we've raised our free cash flow target. If we realized and thought for sure, and we're very comfortable that we would beat those targets, and then at that point we'll raise this target if that becomes necessary. As of today I think $26 million is a respectable number for our growth for 2019. We have a lot on our plate. We took on a lot of debt. We have a lot of construction going on. We have to get all these things lined out. We could have cost overruns. We could have certain little things so we factored for all of the what ifs and until we know whether those what ifs happen or don't happen, $26 million is our number.

Q: I guess I'm actually asking more of an accounting question which we might have to take offline. But the $3 million in additional cash flow when the amortization steps down, is that actually considered additional cash flow?

Eric Langan – President and CEO
That would be cash flow after debt service. You have to remember free cash flow is operating cash flow minus maintenance capex and then you would have debt service that you would take out of there to get your total and any principal we had to pay back. Then you get your total free cash flow for what I would basically consider for use for whatever use after debt service. So what we will have is we'll have $3 million more of disposable cash flow that's not already targeted to pay out down debt service.

Q: Thank you. That's all my questions for now.

Eric Langan – President and CEO
Okay. Thanks, Darren.

Operator
Our next question comes from the line of Doug Weiss with DSW Investments. Please proceed with your question.

Q: Thanks. Good evening. I guess I'm just following up a little bit and I think you addressed this a little bit, but so BDO had some comments in the last K and you guys sort of published what you were doing from a remediation standpoint. Then they seemed to have similar comments in this K. So I guess my question is just, are you working with them so that those issues are resolved this year?

Eric Langan – President and CEO
We've been working on it. The problem is in order for anything to be removed we have to satisfy it through the entire 12-month period. We hired a third-party internal auditing controls company that came in and helped us write a lot of controls. We bought some additional what they call SOD, segregation of duty, software that was installed and put in in May. So we have been working on this throughout the year in order to get a clean bill of health on these internal controls requirements. If you look at what the requirements costs were, we have to meet those requirements for the entire 12-month period. So I think we're going to be much better off for next year. But as you see, we have an unqualified opinion, which means the numbers all checked out. They just had to do a lot of auditing to get to that comfort level they needed to do with the duty. So basically they have to do a lot more sampling or they have to do. Like I said, it was a much larger audit than what we have been typically used to.

Q: And you brought in a new consultant this year or in 2018 to just—

Eric Langan – President and CEO
Yes, I think it's Axia. They basically come in for companies and help write and set up all your internal controls in your accounting or consulting basically to help you meet all the segregation of duty requirements.

Q: Yes, okay. Is BDO proving helpful? When you originally hired them you referred to their experience working with national restaurant chains. Are they helping as you roll out Bombshells in terms of kind of helping you guys take it to the next level?

Eric Langan – President and CEO
I'm unsure at this point. There's been a lot of costs added. We just got the K done and filed. I'm going to be meeting with some board members and the audit committee to discuss the costs. We haven't even put it all together yet. We have their costs. Now we're going to look at the third-party costs that have been generated. We're going to look at all these costs. We're going to have to weigh it out and say okay, are we getting the cost benefit on this to move forward? So it is one of the things we're looking at. Now I know the software change was a big part of some of those additional costs, so we're going to have to look at those options and just sit down with everything and say okay, are we creating some value here. I'll know if we move forward and talk with certain board members and the accounting staff on a go-forward basis on where we're at with all that. I hope we are. I just don't have enough data in front of me right now to be 100% sure.

Q: As a shareholder, I think it's good that you brought in a higher profile auditor. I guess what I'm just scratching my head a little bit about is—and it's been a long time since I have been in public accounting—but it just seems like they could provide a little more guidance. They're sort of saying these are the things you need to improve, but it seems like maybe you guys could are there or maybe not. Maybe you're there at this point.

Eric Langan – President and CEO
Yes. I just don't know. Like I said we're going to be reviewing that over the next few weeks and I'll have a better understanding. We have really for the last four weeks been concentrated on nothing but getting this 10-K filed. We were really hoping to make the 14th and then once we realized that wasn't going to happen from their side, then we had to push everything and we got multiple more samplings requirements on certain things as they were trying things out and going through everything. That's two years in a row of very, very extensive audits of our systems, of our accounting, everything.

Q: No, I understand. And I'd like to think that you're kind of getting the hard work done now and you'll be that much better off as you expand.

Eric Langan – President and CEO
That's the plan for sure.

Q: And then just my other question would be, I think your target is to do two club acquisitions a year plus the Bombshells. Is that still sort of the game plan for this year even with the share price lower?

Eric Langan – President and CEO
We don't really have a target on number of club acquisitions. Because we don't get to choose when the seller will sell to us at a price we're willing to pay, basically with the club acquisitions, we're really looking for the right acquisitions at the right prices that are in line with our management's ability to actually operate and run those, so that helps. As far as the Bombshells, we were planning to do three a year. Since we changed to this new format and we have done basically five locations that we now own the real estate on, I'm going to be a little more cautious through this summer I think for sure. We want to sit down with all these stores opened and I want to start seeing some hard numbers. I want to start seeing the returns on the stores where we own them.

Now the first five stores basically already paid for themselves. We spent about $13 million in capital out. We have about $12.9 million from operations back. So the leased locations are working out fairly decent for us. I want to see how it works out. We're using bank financing, owning the real estate, those types of things on how much value and what our cash-on-cash returns actually turn out to be on those as well. So we'll have a much better idea I think by the end of the summer or maybe even the end of the fiscal year. Maybe we'll run it all the way into September before we really start looking at more Bombshells at this point unless of course something changes.

We're always optimistic when the right opportunity poses itself. It's just at this point right now I think with our stock price where it's at, we're a lot less risk adverse than we were say when our stock was $34 a share and we are looking at our return on buying back our stock was low single-digits. It wasn't as interesting, so we had to put that cash to work. Right now we have a pretty easy way of putting our cash to work and getting over 13% returns on our free cash flow.

Q: Alright. Okay. I appreciate the answers and Happy New Year.

Eric Langan – President and CEO
Yes. Happy New Year. Thanks.

Operator
Our next question comes from the line of Peter Siris, private investor. Please proceed with your question.

Q: Hi, Eric.

Eric Langan – President and CEO
Hi, Peter. How are you?

Q: First I have a comment which as somebody who has run audit committees for many public companies and has in many instances changed from lower-level accountants auditors to big time auditors, it is a pain in the butt. The amount of time and energy that you expend—once it gets to work, it's fine, but I understand the frustration that you're going through. I just want to tell you I have lived it and everybody else who's done it has lived it.

Eric Langan – President and CEO
We appreciate it. I don't know if I'd have done it if I'd have known how hard it was going to be, but we have learned a lot. I will say we have learned a lot and I think our ERP system is much, much stronger for a go-forward basis because of it.

Q: Nothing that's happened with an ERP system and change in auditors is a surprise to me. Chapter and verse, this is standard operating procedure. Anybody who puts in an ERP system and upgrades the auditors goes through the same stuff.

Eric Langan – President and CEO
I would recommend doing one at a time in the future to other people.

Q: Absolutely. Going through both at once is hell.

Eric Langan – President and CEO
So you have known me a long time. I don't too many things the easy way.

Q: I want to ask you a question about Bombshells and then about acquisitions. On Bombshells, if you went back to the beginning and sort of looked at what's happened, what mistakes have you made with Bombshells?

Eric Langan – President and CEO
The first one was Webster where we went to a Class D/Class C location which we know does not work now. Restaurants are not like strip clubs. They're not destination locations. They are like every other restaurant. So we had to be in a top notch restaurant Class A locations and since we have done that we're doing very, very well with every location we have opened so far.

Second, obviously like the Willowbrook deal, if we do a lease we will definitely make sure that our patio and the rights to our patio are absolutely 100% spelled out in that lease which was an early deal. Most patios just aren't in leases, but in our leases they are most definitely prominent in them now, because the patio plays such an important part of the overall concept and without it the concept isn't the same. So those are our few biggest ones.

We might have had a couple times where we pushed a little fast, but overall I think we're in great shape. I probably would have started buying real estate sooner but I didn't have the bank financing back then. So it's hard to say whether it was a mistake or whether we did what we had to do to get to where we are.

Q: This is not meant to be a criticism since I've been around for a long time, but as you expanded your clubs you also made mistakes and then you learn from them.

Eric Langan – President and CEO
We did.

Q: If you don't make mistakes you aren't trying.

Eric Langan – President and CEO
Yes of course. I think we have learned a lot definitely on the club side. There's no doubt there. And on the Bombshells we're learning as we go, but our sales are still strong. We're still making money. Even our worst location, which is probably an A- location in Austin, today I would build that location. If I was looking at that market today I would build that location two exits south of where it is and my numbers would be $20,000/$30,000 a week higher than they are. I know because another concept built down there in a property that I saw and they're doing fantastic. It's not the same concept as ours, but it's just a restaurant that's doing very, very well in that site.

We've learned from our early stores which ones work and which ones don't and these five stores that we're building in Houston are all freeway locations, all very high visibility, and they're opening up to huge startup numbers. The numbers they're starting out—they're going to run I think $90,000 to $110,000 a week in average sales as they go on. So you're talking about restaurants doing $5 million a year.

Q: That's pretty good.

Eric Langan – President and CEO
And we're having $1.5 million/$2 million max cap in them including the land building, everything and the rest we're financing over 20 years, at 5.25% interest. I think it's going to be really nice as we open these other things. The biggest problem I think we're seeing right now is you're seeing us brush up against a three times EBITDA to debt ratio and it's because we have a lot of money invested in these Bombshells that aren't open yet. We borrowed a lot of that money for the acquisitions at the end of September but we didn't close until November. But we had to because under the contract we had to close within five days of the licensing being approved and those licenses could have been approved at any time from late September all the way through December. Who knows? But we lucked out. Both literally were approved within a week of each other in November, so that worked out really well for us.

Q: And the expenses and the interest and all of that, that's in these numbers. It's not hidden away somewhere in pre-opening expenses, right?

Eric Langan – President and CEO
Exactly. All of our debt and all the interest expenses are all expenses as we create them and as we borrow.

Q: Just as a suggestion, if you're ever in a position where you're doing a lot of opening and you can indicate in a press release or something what the earnings would have been without pre-opening expenses.

Eric Langan – President and CEO
We did that in the past when it was a significant amount number, but the average Bombshells for us it's just not—and we're doing such high sales the first week. To give you an idea, we did $160,000 the first week in Pearland. We did about $140,000 in I-10 and we opened up six days before Christmas Eve. So I think that store is going to be phenomenal as we move through the next few weeks towards Super Bowl. January's going to be a really big month for that new location.

Q: Great. Last question, what are you seeing as far as acquisition opportunities in the strip club business or gentlemen's club business?

Eric Langan – President and CEO
We're seeing stuff everywhere. A lot of new markets are opening up with clubs that haven't been for sale in the past. We're looking at a lot of stuff. We're talking with a lot of people. We'll get serious.

I think in March, hopefully we'll see what the stock does, but by March our financial side is going to be very, very good. In March/April-ish, as we pay off the $5 million short-term notes, we're going to be very close to having the other stuff paid off. We have some properties under contract right now that we're selling as that property becomes sold. We're working on a couple of leases right now to get those leases done. That's going to free up cash flow on a go-forward basis. So I think we'll get very, very active on the club acquisition or we're going to be buying back a ton of stock depending on what the stock price does as we move into March, April, May and going forward. And the Bombshells will be done, so all of that upfront capital will be done going out as well. The cash flow outlook is really going to change as we move into April, May and June, I think.

Q: Fantastic. Well, Eric, have a Happy New Year and it's good talking to you.

Eric Langan – President and CEO
You, too.

Operator
Our next question comes from the line of Joe Wang, private investor. Please proceed with your question.

Q: My question is you made a large emphasis on the stock buyback below $27, but I saw in your earnings release that there's only roughly $3.1 million in authorization.

Eric Langan – President and CEO
Yes. We typically run down pretty low. It's a matter of just a board meeting to increase it and it's become pretty regular for us. I think we have approved four or five buybacks in the last few years. In fact, it's actually on the agenda for my next board meeting to talk to our board members about increasing it. It's a fairly simple process to increase the amount of authorized buybacks.

Q: Okay. Thank you. It just seemed kind of curious that you didn't have the board meeting before this earnings call.

Eric Langan – President and CEO
We've been working on the K, buddy. You know how much work we've been through? Phone calls until 3:00 or 4:00 in the morning, 6:00 in the morning, back up, back down, sending people on weekends to the corporate office, pulling documents, pulling different stuff. It's been a very tiresome and a long, long experience to get this out today.

Q: Yes, okay. Thank you. It really shouldn't be this hard to get the K out.

Eric Langan – President and CEO
It shouldn't and hopefully it won't be. It wasn't for 21 years. That's all I can say. Twenty-one years we never had an issue and the last two years have been a big learning experience for us for sure.

Q: Yes. It just shouldn't be happening at a public company. Thank you.

Eric Langan – President and CEO
Yes. Thank you.

Operator
Ladies and gentlemen, we have reached the end of the question-and-answer session and I would like to turn the call back to Gary Fishman for closing remarks.

Gary Fishman – Investor Relations
Thank you and thank you, Eric. We have included a couple of supplemental slides in our appendix slide 19 as our preliminary calendar for the year. As Eric mentioned, the next event is our first quarter sales and at the end of the day we'll have a conference call that'll be on Thursday, January 10th. On behalf of Eric, the company and our subsidiaries, thank you and goodnight. And as always, please visit one of our clubs or restaurants and best wishes to everybody for a happy, healthy and prosperous New Year. Thank you.