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Transcript of
RCI Hospitality Holdings, Inc.
First Quarter 2019 Earnings Call and Webcast
February 11, 2019

Participants

Gary Fishman - Investor Relations
Eric Langan - President and Chief Executive Officer

Analysts

Frank Camma - Sidoti & Company
Marco Rodriguez - Stonegate Capital Partners
Darren McCammon - Cash Flow Kingdom

Presentation

Operator
Greetings, and welcome to the RCI Hospitality Holdings Fiscal 2019 First Quarter Results 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. Thank you. You may begin.

Gary Fishman - Investor Relations
Thank you. For those of you listening to this call on the phone, you can find our presentation on the RCI website. Click Company and Investor Information just under the RCI logo. That will take you to the Company Investor Info page, scroll down a little and you'll find all the necessary links for this call.

Please turn to Slide 2. I want to remind everybody of our safe harbor statement. It is 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 of non-GAAP measurements that we use and are included in our presentation and newscast.

Finally, I'd like to invite everyone listening in the New York City area to join us tonight at 6 o'clock to meet management at Rick's Cabaret New York, Manhattan's #1 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, right 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 Langan - President and Chief Executive Officer

Thank you, Gary. Thank you everyone for joining us this afternoon. If you will please turn to Slide 4 to review today's news.

We generated strong first quarter results. Total revenues increased 6.8% to $44 million and GAAP EPS was $0.65, compared to $1.47 a year ago. This year's first quarter included $1.2 million in pre-tax gain from the sale of non-income producing assets. It also included $447,000 in pre-tax non-operating loss. This reflected implementation of a new accounting standard for changes in the market value of equity securities.

On the other hand, the year-ago quarter included $9.7 million in deferred tax credit as a result of federal tax reform. The year-ago quarter also included $900,000 in debt issuance cost write-offs and prepayment penalties related to our large Centennial Bank refinancing. On a non-GAAP basis, which eliminates all of these items and some others, EPS was $0.61, up 15% year-over-year and free cash flow was $11.1 million, up 47%.

In line with our capital allocation strategy, and given where the stock was trading, we began buying back shares in the first quarter. We have been active here in the second quarter as well. All together from October through January, we bought 28,211 shares in the open market.

We continue to maintain our positive outlook for the year and our $26 million free cash flow target. I'll talk more about our free cash flow dynamics on Slide 8.

I would like to note that in the 10-Q filed today, we identified mechanical errors in our goodwill impairment analysis in our fiscal 2018 10-K. It involved tax rate and debt service assumptions for two clubs in Texas and resulted in an additional impairment of $834,000. This is a non-cash item. It was also considered to be an immaterial revision and has no effect on our first quarter results.

If you'll please turn to Slide 5. Sales were primarily driven by a 7.1% year-over-year increase in night clubs, and to a lesser degree 3.2% increase in Bombshells. As previously reported, Nightclubs same-store sales were up 4.3%, while Bombshells were down. The latter was more than made up for by our Pearland location and a week or so of the new I-10 location, both in the greater Houston area.

GAAP operating income increased 21.8% or $2 million. That was driven by a $2 million improvement in night clubs. The segment benefitted from higher revenues, in particular higher service revenues, and that $1.2 million gain on sale. But, Nightclubs also saw higher legal expenses in part due to the Chicago and Pittsburgh acquisitions.

Bombshells' profitability reflected reduced operating leverage, while corporate expenses improved due to lower professional fees compared to a year ago. On a non-GAAP basis, which excludes the first quarter gain, operating income increased 9.9% or about $1 million. Margins expanded 64 basis points to 23.1% of revenue.

Please turn to Slide 6 to review sales of non-income producing assets. We sold three assets in the first quarter for $1.9 million, resulting in a $1.2 million gain, including where the former Club Onyx Philadelphia business, our former corporate offices and related real estate, and a small parcel in San Antonio. Collectively, we received $1.2 million in cash and $625,000 promissory note. The cash was used in part to pay down close to $1 million in related real estate debt.

Subsequent to the quarter, we sold an excess parking lot near the former Club Onyx in Dallas. The sales price was $1.4 million with $250,000 paid upfront in cash and the remaining $1.15 million payable in the form of a three-year seller note at 8%. We expect to record a pre-tax gain of approximately $383,000 in the second quarter results.

At the end of January, the only assets we held for sale were two excess parcels near Bombshells I-10 and US 249. We anticipate closing those sales soon. We have several other tracks near our Bombshells locations that we hope to have under contract in this fiscal year.

I would like to note that the sale of non-income producing former club-related assets stems from our capital allocation strategy. In fiscal 2016, we took a good hard look at our assets. We wanted to dispose of assets that were not providing us with adequate return, and we wanted to turn money-losing assets into money-making assets or free up as much capital as possible for more productive purposes. This is what these bigger asset sales in the first quarter and in January were about.

Please turn to Slide 7 for a review of sales and margins. At $44 million, the first quarter of 2019 was a record quarter and it marked the eleventh quarter in a row of total same-store sales increases. This is the longest streak we've ever had. While operating margin can fluctuate between quarters due to the seasonality of our business, you can see on this slide that we have been making progress, expanding margin as we grow larger. We hope to keep that up.

Please turn to Slide 8 for a review of cash generation. Our cash totaled $9.4 million at December 31st. We had $17.7 million at September 30th. The September balance included proceeds from debt used to finance the cash portion of the two November club acquisitions and the related real estate.

Adjusted EBITDA performed well, increasing 8.4% year-over-year to $12 million. Free cash flow for the first quarter had an impressive performance. It was $11.1 million versus $7.5 million in the year-ago period. I'd like to caution you not to get ahead of us with this. Sometimes the first quarter has a bit of a tailwind, due to changes in working capital when we pay a lot of bills at the end of the fourth quarter and pay fewer in the first quarter. This benefits free cash flow. We will let you know when we feel comfortable whether we are likely to exceed our initial $26 million target.

Please turn to Slide 9. Our strategy for capital allocation remains the same. We've adjusted our graph on this slide to take into account our slightly lower share count due to share buybacks. But the general parameter is that $27 continues to be the break point for buying shares at our current free cash flow run rate. As I mentioned at the start of the call, we relaunched our buyback program when the stock began to soften in the first quarter. After the 10-K was filed, we began purchasing again in January. We'll continue to do so in our standard and judicious manner.

Please turn to Slide 10. Long-term debt increased a net $12.5 million from September 30th. This was primarily due to the addition of $12 million in seller financing for the Chicago and Pittsburgh club acquisitions in November, which is secured by those clubs' assets. Our weighted average interest rate increased only 10 basis points, and in total 85% of our long-term debt is secured.

Please turn to Slide 11. While slightly higher, debt continues to be manageable. We are paying down our $5 million bank line of credit installment loan with Centennial that was used to finance the Chicago and Pittsburgh acquisitions. As of December 31st, the balance was $3.1 million and that should be paid off by the end of April. We continue to be on track for our large Centennial real estate loan to be 65% or less loan-to-value by the end of fiscal 2019. At that point amortizations will drop $250,000 a month, freeing up $3 million on an annualized basis.

Looking further ahead, the $3.1 million realty balloon in Fiscal 2020 relates to excess Bombshells parcels. We plan to sell those before that becomes due. As you know, we also look at occupancy costs and debt to adjusted EBITDA for debt manageability. Occupancy costs are rent plus interest as a percent of revenues. Both of these metrics increased in the first quarter. That was a function of the debt we raised in advance of the Chicago and

Pittsburgh acquisitions, as well as debt related to the construction of new Bombshells locations. Occupancy costs and the debt ratio should decline with a full quarter of Chicago and Pittsburgh clubs and Bombshells I-10 in the second period and then as the other three Bombshells open.

Please turn to Slide 12 and 13 to recap our Fiscal 2019 plan. In Nightclubs, we will continue to complete the integration of Chicago and Pittsburgh. Most recently they were renamed Rick's Cabaret, expanding the higher-end gentlemen's club chain to nine locations. We must also keep our eyes open for the right club acquisitions at the right price.

With Bombshells, we will complete and open the three remaining units under construction and then review our progress. We will also focus on improving same-store sales. I'm pleased to report that the January Bombshells same-store sales were down only a single-digit percentage.

As for our balance sheet, we anticipate closing sales on the excess Bombshells parcels at prices that should enable us to reduce our debt on the actual Bombshells investment, and we will pay down the Centennial loan in order to drop our monthly amortization and free up cash.

With regards to margins, we continue to look for ways to reduce costs, and with capital allocation, we will continue the strategy that has worked so well for us.

Thank you to all of our investors for supporting us and all of our staff for doing a great job. It is truly appreciated. Operator, let's begin the question and answer session.

Operator
Thank you. [Operator instructions]. Our first question is from Frank Camma with Sidoti & Company. Please proceed with your question.

Q: Good afternoon, guys. Thanks for taking the question. The beat to my number, when I adjust the numbers, was pretty nice considering we already knew the revenue and it sounds like when I go through my model, it really goes down, boils down to the service revenue and a margin to that which you actually called out. Why would that be so strong in the quarter? It seemed pretty outstanding, so, just wondering was there something particular there that I'm missing, is the mix or something like that, or just it continues to be strong because of consumer confidence.

Eric Langan - President and Chief Executive Officer
Yes. We had a very, very strong December, especially for service revenues in three of our markets, in Florida, New York, and Minnesota, which carried a bunch of it, and part of it was also the sale of assets.

Q: Oh, you mean as far as getting rid of some weaker revenue producers. So, it is kind of a mix when you look at it from that perspective, right?

Eric Langan - President and Chief Executive Officer
Yes.

Q: Okay. Alright. And so I know you focus a lot on capital allocation, you have a pretty clear strategy. One question on that, obviously you keep throwing better and better free cash flow and one of your priorities is to buy back shares, which I totally appreciate, but do you worry it gets a little self-defeating given just sort of your market cap, as far as taking out some liquidity? I just wonder if you have any thoughts there.

Eric Langan - President and Chief Executive Officer
When the stock was $6 that was a problem because we were buying a large number of shares with very small amounts of money, but with the stock in the $22, $23 range as you can see, we spent well over six hundred and some thousand dollars between basically November and January and we bought 28,000 shares. So, I don't see it being a problem. Taking out 3% to 5% of our float in a calendar year at this point, I don't see that being a huge issue. I certainly think there are plenty of shares out there in the float that will trade.

Q: Sure. Okay. And just one quick question on Bombshells. I didn't catch—you made a comment about the—did you say the first, the January numbers were down to single-digit comp declines? Is that what you said?

Eric Langan - President and Chief Executive Officer
Yes, we were down less than 10% in January for Bombshells. We've got some pretty good programs in right now, training management. These stores are opening. The construction is moving along on the other three locations, which are exciting our management team, and we've been marketing and hiring new management to help build and train further new stores. And that's helping to re-motivate our existing stores.

Q: Okay. And it looks like the schedule is unchanged, I think, compared to [indiscernible] but looks like the opening schedule is exactly the same as for right now.

Eric Langan - President and Chief Executive Officer
Yes, right now we're on schedule. The only thing is the 249 store could run into early March, first week of March or something if inspections run over, if we have any inspection issues because those are out of our control. Everything within our control it will be on time and we don't suspect we'll have any issues, but they're always possible. But I don't think we would be any later than the 10th of March opening, and I think we can be as early as right around the end of February.

Q: Okay. Great. Thanks, Eric.

Eric Langan - President and Chief Executive Officer
We're planning on right now to get open for that first weekend in March.

Q: Good, thanks.

Operator
Our next question is from Marco Rodriguez with Stonegate Capital Partners. Please proceed with your question.

Q: Good afternoon. Thanks for taking my questions. I was wondering if we could talk a little bit about Bombshells and the operating margins non-GAAP obviously, down here in a single-digit area. Just trying to understand if this is just a function of the same-store sales aspects, or were there are other sort of promotional activities that are kind of driving that down versus historical numbers.

Eric Langan - President and Chief Executive Officer
I'll tell you what really drove it down was legal. We paid some pretty heavy legal bills in that quarter that we left as normal. We also had some depreciation and changes with the way some of the depreciation and deferred rents were booked in this quarter. Some of those changes hit in this quarter as well, because of the way we did the write-offs in the year-end or something.

They were trying to explain to me exactly all these details that have happened. It was crazy. I can look at the cash and see we generated all this cash from Bombshells but you're telling me I didn't make any money. It doesn't make any sense. Some of the non-cash stuff kind of worked through there. But because of the way it's booked, it's GAAP. It could be affected into the non-GAAP number as well. So none of it was subtracted for non-GAAP purposes.

Q: Understood. So, is that going to reverse itself come the second half of this fiscal year for you on Bombshells or do you expect it to come back up to that 15% to 20% operating margin? Or, is that going to be a lingering effect?

Eric Langan - President and Chief Executive Officer
It should. Yes. I think we're going to see a much different quarter this quarter. I know we'll get an idea where it's kind of headed, from January and February to March. We won't have legal bills. The county dismissed the case with prejudice, so that's all in the past for us. We're not going to be facing those legal fees anymore.

The deferred rent issue is booked and worked out now. So, it's going to be normalized rent going forward on those locations. And the stuff on whatever the deal was with the Austin location is all in the past now, too. So, I think, we're going to see a normalized quarter this quarter. I'm hoping so anyway. I'm having hard time myself figuring out all these adjustments that they did.

I went back to the cash flow and said okay, forget all that, show me all the stuff that's non-cash, and take it out. Show me what we're doing in cash. Okay, we're doing good numbers in cash.

Q: That's helpful. Then, kind of shifting gears here to the Nightclubs. I was wondering if maybe you can just kind of update us a little bit here on Chicago and Pittsburgh. I know it's still early days, but how is that progressing versus your expectations?

Eric Langan - President and Chief Executive Officer
Pittsburgh is doing great, a little ahead. Chicago had some extreme weather. All three of our Illinois clubs, St. Louis, Kappa and Chicago are all affected by the big snowstorms and stuff, as well as Minnesota, a little bit in January. Of course, this year, we didn't have the Super Bowl in Minnesota. There are certain markets that are down a little bit. But overall, I would say we're flat to down a little bit through the first five weeks in the Nightclubs, but we have the NBA All Star game coming up in Charlotte, which will give us a big boost that week. And then, we have some really good lineups for the March Madness. And then of course in April, we will have the Final Four in Minnesota.

Even if this quarter is down a little bit, we'll make it all back up in the April quarter, but I'm hoping, we're all pushing, we've got our team. We know we've had 11 consecutive quarters of same-store sales growth and we have all the teams pushing in these next 8 weeks to beat last year's numbers so that we have a boost in same-store sales for the twelfth consecutive quarter. But this is a tough comp quarter for us for sure.

Q: Understood, got you. And then in terms of the acquisition landscape for Nightclubs, if you could kind of update us there, if you have some possibilities that are moving along the line, further down the line if you will, to potential close.

Eric Langan - President and Chief Executive Officer
We're looking at several still. I would say, I don't think, we do anything in this quarter, unless something extreme popped up that we just couldn't say no. But we are getting serious on a couple that we would move forward on probably the April to June quarter.

Q: Got you. Thanks a lot, guys. Appreciate your time.

Eric Langan - President and Chief Executive Officer
Thank you.

Operator
[Operator instructions]. Our next question is from Darren McCammon with Cash Flow Kingdom. Please proceed with your question.

Q: Hi, guys. Most of my questions have already been asked, so I just really have two. First, on the margin improvement that we saw this quarter, is that something we expect to continue or is it just a one-time kind of thing?

Eric Langan - President and Chief Executive Officer
As you've seen in the past, it fluctuates from quarter to quarter and it's going to depend on how service revenue continues through the rest of this quarter and how it does for March Madness. March will be the real tale of how the quarter is going to go, as it always is for the January, February, March quarter.

Q: What is the specific service revenue that did better this quarter?

Eric Langan - President and Chief Executive Officer
All of our VIP and service revenues. There were more people through the door in December, bigger parties in December, just a little bit of a little bit of everywhere.

Q: Okay. And then on the $11.1 million in free cash flow, I know a nice chunk of that must be changes in working capital. Can you tell us, give us an idea how much?

Eric Langan - President and Chief Executive Officer
I don't know off the top of my head. I can get with Phil and the team and get you that number, though.

Q: Okay, well, I'll be able to see it once the—

Eric Langan - President and Chief Executive Officer
In the Q. Yes, it will definitely show up in the Q.

Q: Okay, that's all I had. Thank you.

Eric Langan - President and Chief Executive Officer
Thank you.

Operator
[Operator instructions]. Are there any final questions? This will be the last chance for questions. We will pause for a brief moment.

There are no more questions at this time. I would like to turn the conference back over to management for closing remarks.

Gary Fishman - Investor Relations
Thank you, operator, and thank you, Eric. We've included a few supplemental slides in our appendix. Slide 18 is our calendar for those who joined us late. You can meet management tonight at Rick's Cabaret New York from 6 o' clock to 8 o'clock, at 50 West 33rd Street between Fifth and Broadway. If you haven't RSVP-ed, ask for me at the door.

The next event on our calendar is our appearance March 28th at the Sidoti & Company Spring Investor Conference in New York City. The registration is free for professional investors. We encourage our tri-state area investors to attend our presentation or sign up for a one-on-one. For those based out of town, use it as a reason to come to New York City and see us. And on April 9th, we're currently scheduled to report second quarter Nightclub and Bombshells sales.

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