
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2019

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number: 001-13992

RCI HOSPITALITY HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

Texas
(State or other jurisdiction of
incorporation or organization)

76-0458229
(I.R.S. Employer
Identification No.)

10737 Cutten Road
Houston, Texas 77066
(Address of principal executive offices) (Zip Code)

(281) 397-6730
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

| <u>Title of each class</u> | <u>Trading Symbol(s)</u> | <u>Name of each exchange on which registered</u> |
|--------------------------------|--------------------------|--|
| Common stock, \$0.01 par value | RICK | The Nasdaq Global Market |

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of August 31, 2019, 9,616,598 shares of the registrant's common stock were outstanding.

NOTE ABOUT FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include, among other things, statements regarding plans, objectives, goals, strategies, future events or performance and underlying assumptions and other statements, which are other than statements of historical facts. Forward-looking statements may appear throughout this report, including, without limitation, the following sections: Part I, Item 2 “Management’s Discussion and Analysis of Financial Condition and Results of Operations.” Forward-looking statements generally can be identified by words such as “anticipates,” “believes,” “estimates,” “expects,” “intends,” “plans,” “predicts,” “projects,” “will be,” “will continue,” “will likely result,” and similar expressions. These forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties, which could cause our actual results to differ materially from those reflected in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this Quarterly Report on Form 10-Q and those discussed in other documents we file with the Securities and Exchange Commission (“SEC”). Important factors that in our view could cause material adverse effects on our financial condition and results of operations include, but are not limited to, the risks and uncertainties associated with (i) operating and managing an adult business, (ii) the business climates in cities where it operates, (iii) the success or lack thereof in launching and building the company’s businesses, (iv) cyber security, (v) conditions relevant to real estate transactions, (vi) our ability to regain and maintain compliance with the filing requirements of the SEC and the Nasdaq Stock Market, and (vii) numerous other factors such as laws governing the operation of adult entertainment businesses, competition and dependence on key personnel. We undertake no obligation to revise or publicly release the results of any revision to any forward-looking statements, except as required by law. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements.

As used herein, the “Company,” “we,” “our,” and similar terms include RCI Hospitality Holdings, Inc. and its subsidiaries, unless the context indicates otherwise.

RCI HOSPITALITY HOLDINGS, INC.
FORM 10-Q
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PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

RCI HOSPITALITY HOLDINGS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except par value)

| | <u>March 31, 2019</u> (unaudited) | <u>September 30, 2018</u> (As Revised) |
|---|--------------------------------------|---|
| ASSETS | | |
| Current assets | | |
| Cash and cash equivalents | \$ 8,255 | \$ 17,726 |
| Accounts receivable, net | 5,579 | 7,320 |
| Current portion of notes receivable | 1,142 | - |
| Inventories | 2,597 | 2,353 |
| Prepaid insurance | 2,097 | 4,910 |
| Other current assets | 1,521 | 1,591 |
| Assets held for sale | 668 | 2,902 |
| Total current assets | <u>21,859</u> | <u>36,802</u> |
| Property and equipment, net | 191,966 | 172,403 |
| Notes receivable, net of current portion | 3,859 | 2,874 |
| Goodwill | 55,271 | 43,591 |
| Intangibles, net | 76,441 | 71,532 |
| Other assets | 1,477 | 2,530 |
| Total assets | <u>\$ 350,873</u> | <u>\$ 329,732</u> |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities | | |
| Accounts payable | \$ 3,632 | \$ 2,825 |
| Accrued liabilities | 9,911 | 11,973 |
| Current portion of long-term debt | 10,447 | 19,047 |
| Total current liabilities | <u>23,990</u> | <u>33,845</u> |
| Deferred tax liability | 21,970 | 19,552 |
| Long-term debt, net of current portion and debt discount and issuance costs | 139,371 | 121,580 |
| Other long-term liabilities | 1,606 | 1,423 |
| Total liabilities | <u>186,937</u> | <u>176,400</u> |
| Commitments and contingencies (Note 10) | | |
| Stockholders' equity | | |
| Preferred stock, \$0.10 par value per share; 1,000 shares authorized; none issued and outstanding | - | - |
| Common stock, \$0.01 par value per share; 20,000 shares authorized; 9,634 and 9,719 shares issued and outstanding as of March 31, 2019 and September 30, 2018, respectively | 96 | 97 |
| Additional paid-in capital | 62,252 | 64,212 |
| Retained earnings | 101,623 | 88,906 |
| Accumulated other comprehensive income | - | 220 |
| Total RCIHH stockholders' equity | <u>163,971</u> | <u>153,435</u> |
| Noncontrolling interests | (35) | (103) |
| Total stockholders' equity | <u>163,936</u> | <u>153,332</u> |
| Total liabilities and stockholders' equity | <u>\$ 350,873</u> | <u>\$ 329,732</u> |

See accompanying notes to unaudited condensed consolidated financial statements.

RCI HOSPITALITY HOLDINGS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except per share data)
(unaudited)

| | For the Three Months Ended March 31, | | For the Six Months Ended March 31, | |
|--|---|-----------------|---------------------------------------|------------------|
| | 2019 | 2018 | 2019 | 2018 |
| Revenues | | | | |
| Sales of alcoholic beverages | \$ 18,486 | \$ 17,372 | \$ 36,796 | \$ 35,177 |
| Sales of food and merchandise | 6,439 | 5,424 | 12,129 | 10,731 |
| Service revenues | 16,979 | 16,133 | 34,310 | 32,022 |
| Other | 2,922 | 2,297 | 5,614 | 4,508 |
| Total revenues | <u>44,826</u> | <u>41,226</u> | <u>88,849</u> | <u>82,438</u> |
| Operating expenses | | | | |
| Cost of goods sold | | | | |
| Alcoholic beverages sold | 3,790 | 3,589 | 7,526 | 7,344 |
| Food and merchandise sold | 2,308 | 1,964 | 4,292 | 4,058 |
| Service and other | 94 | 43 | 186 | 79 |
| Total cost of goods sold (exclusive of items shown separately below) | 6,192 | 5,596 | 12,004 | 11,481 |
| Salaries and wages | 11,908 | 10,347 | 24,004 | 21,724 |
| Selling, general and administrative | 14,341 | 12,848 | 28,368 | 25,660 |
| Depreciation and amortization | 2,200 | 1,899 | 4,253 | 3,808 |
| Other charges (gains), net | (981) | 2,305 | (2,078) | 2,394 |
| Total operating expenses | <u>33,660</u> | <u>32,995</u> | <u>66,551</u> | <u>65,067</u> |
| Income from operations | 11,166 | 8,231 | 22,298 | 17,371 |
| Other income (expenses) | | | | |
| Interest expense | (2,645) | (2,106) | (5,166) | (5,185) |
| Interest income | 75 | 68 | 126 | 135 |
| Non-operating gains (losses), net | 77 | - | (370) | - |
| Income before income taxes | 8,673 | 6,193 | 16,888 | 12,321 |
| Income tax expense (benefit) | 1,930 | 1,499 | 3,741 | (6,728) |
| Net income | 6,743 | 4,694 | 13,147 | 19,049 |
| Net income attributable to noncontrolling interests | (8) | (9) | (68) | (53) |
| Net income attributable to RCIHH common stockholders | <u>\$ 6,735</u> | <u>\$ 4,685</u> | <u>\$ 13,079</u> | <u>\$ 18,996</u> |
| Earnings per share | | | | |
| Basic and diluted | \$ 0.70 | \$ 0.48 | \$ 1.35 | \$ 1.95 |
| Weighted average number of common shares outstanding | | | | |
| Basic and diluted | 9,679 | 9,719 | 9,696 | 9,719 |
| Dividends per share | \$ 0.03 | \$ 0.03 | \$ 0.06 | \$ 0.06 |

See accompanying notes to unaudited condensed consolidated financial statements.

RCI HOSPITALITY HOLDINGS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(in thousands)
(unaudited)

| | Common Stock | | Additional Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Income | Treasury Stock | | Noncontrolling Interests | Total Stockholders' Equity |
|--|---------------------|--------|----------------------------------|----------------------|---|---------------------|---------|-----------------------------|----------------------------------|
| | Number of Shares | Amount | | | | Number of Shares | Amount | | |
| Balance at September 30, 2018 | 9,719 | \$ 97 | \$ 64,212 | \$ 88,906 | \$ 220 | - | \$ - | \$ (103) | \$ 153,332 |
| Reclassification upon adoption of ASU 2016-01 | - | - | - | 220 | (220) | - | - | - | - |
| Purchase of treasury shares | - | - | - | - | - | (14) | (355) | - | (355) |
| Canceled treasury shares | (14) | - | (355) | - | - | 14 | 355 | - | - |
| Payment of dividends | - | - | - | (291) | - | - | - | - | (291) |
| Net income | - | - | - | 6,344 | - | - | - | 60 | 6,404 |
| Balance at December 31, 2018 | 9,705 | \$ 97 | \$ 63,857 | \$ 95,179 | \$ - | - | \$ - | \$ (43) | \$ 159,090 |
| Purchase of treasury shares | - | - | - | - | - | (71) | (1,606) | - | (1,606) |
| Canceled treasury shares | (71) | (1) | (1,605) | - | - | 71 | 1,606 | - | - |
| Payment of dividends | - | - | - | (291) | - | - | - | - | (291) |
| Net income | - | - | - | 6,735 | - | - | - | 8 | 6,743 |
| Balance at March 31, 2019 | 9,634 | \$ 96 | \$ 62,252 | \$ 101,623 | \$ - | - | \$ - | \$ (35) | \$ 163,936 |
| Balance at September 30, 2017 | 9,719 | \$ 97 | \$ 63,453 | \$ 69,195 | \$ - | - | \$ - | \$ 2,480 | \$ 135,225 |
| Payment of dividends | - | - | - | (292) | - | - | - | - | (292) |
| Payments to noncontrolling interests | - | - | - | - | - | - | - | (54) | (54) |
| Net income | - | - | - | 14,311 | - | - | - | 44 | 14,355 |
| Balance at December 31, 2017 | 9,719 | \$ 97 | \$ 63,453 | \$ 83,214 | \$ - | - | \$ - | \$ 2,470 | \$ 149,234 |
| Payments to noncontrolling interests | - | - | - | - | - | - | - | (54) | (54) |
| Payment of dividends | - | - | - | (291) | - | - | - | - | (291) |
| Net income | - | - | - | 4,685 | - | - | - | 9 | 4,694 |
| Balance at March 31, 2018 | 9,719 | \$ 97 | \$ 63,453 | \$ 87,608 | \$ - | - | \$ - | \$ 2,425 | \$ 153,583 |

See accompanying notes to unaudited condensed consolidated financial statements.

RCI HOSPITALITY HOLDINGS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

| | For the Six Months Ended March 31, | |
|---|---------------------------------------|------------------|
| | 2019 | 2018 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net income | \$ 13,147 | \$ 19,049 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 4,253 | 3,808 |
| Deferred income tax expense (benefit) | 1,131 | (9,659) |
| Loss (gain) on sale of businesses and assets | (2,197) | 140 |
| Impairment of assets | - | 1,550 |
| Amortization of debt discount and issuance costs | 202 | 384 |
| Deferred rent | 189 | 149 |
| Gain on insurance settlement | - | (20) |
| Unrealized loss on equity securities | 370 | - |
| Debt prepayment penalty | - | 543 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 1,727 | (2,033) |
| Inventories | (182) | (283) |
| Prepaid insurance, other current assets and other assets | 3,550 | 704 |
| Accounts payable and accrued liabilities | (1,219) | (255) |
| Net cash provided by operating activities | <u>20,971</u> | <u>14,077</u> |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Proceeds from sale of businesses and assets | 2,866 | 632 |
| Proceeds from insurance | - | 20 |
| Proceeds from notes receivable | 68 | 68 |
| Issuance of note receivable | (420) | - |
| Additions to property and equipment | (13,902) | (9,011) |
| Acquisition of businesses, net of cash acquired | (13,500) | - |
| Net cash used in investing activities | <u>(24,888)</u> | <u>(8,291)</u> |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Proceeds from long-term debt | 10,296 | 62,453 |
| Payments on long-term debt | (13,287) | (63,518) |
| Debt prepayment penalty | - | (543) |
| Purchase of treasury stock | (1,961) | - |
| Payment of dividends | (582) | (583) |
| Payment of loan origination costs | (20) | (909) |
| Distribution to noncontrolling interests | - | (108) |
| Net cash used in financing activities | <u>(5,554)</u> | <u>(3,208)</u> |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | (9,471) | 2,578 |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 17,726 | 9,922 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | <u>\$ 8,255</u> | <u>\$ 12,500</u> |
| CASH PAID DURING PERIOD FOR: | | |
| Interest, net of amounts capitalized | <u>\$ 5,173</u> | <u>\$ 4,966</u> |
| Income taxes | <u>\$ 319</u> | <u>\$ 1,903</u> |

See accompanying notes to unaudited condensed consolidated financial statements.

Non-cash and other transactions:

During the six months ended March 31, 2019, in conjunction with the borrowings of \$2.35 million from certain investors, the Company exchanged two notes payable with principal balances of \$300,000 and \$100,000 for two new notes amounting to \$450,000 and \$200,000, respectively. The Company received cash amounting to \$1.95 million on the entire transaction. See Note 6.

During the six months ended March 31, 2019, the Company acquired two clubs for a total acquisition price of \$25.5 million by paying a total of \$13.5 million at closing and executing three seller-financed notes for a total of \$12.0 million. See Note 14.

During the six months ended March 31, 2019, the Company sold a nightclub in Philadelphia for a total sales price of \$1.0 million, payable \$375,000 in cash at closing and a \$625,000 note receivable. See Note 14.

During the six months ended March 31, 2019, the Company sold a held-for-sale property in Dallas, Texas for a total sales price of \$1.4 million, payable \$163,000 in cash at closing, net of closing costs and property taxes of \$87,000, and a \$1.15 million note receivable. See Note 14.

During the six months ended March 31, 2018, the Company refinanced \$81.2 million of long-term debt comprised of 21 notes payable with the execution of three notes payable with a lender bank. The new notes and the repaid balance included \$18.7 million worth of debt with the same lender bank.

During the six months ended March 31, 2018, the Company borrowed \$7.1 million from a lender to purchase an aircraft by trading in an aircraft that the Company owned and the assumption of the old aircraft's note payable liability.

During the six months ended March 31, 2018, the Company refinanced a bank note with a balance of \$1.9 million, bearing interest of 2% over prime with a 5.5% floor, with the same bank for a construction loan with maximum availability of \$4.7 million.

RCI HOSPITALITY HOLDINGS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of RCI Hospitality Holdings, Inc. (the “Company” or “RCIHH”) have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP” or “U.S. GAAP”) for interim financial information and with the instructions to Form 10-Q of Regulation S-X. They do not include all information and footnotes required by GAAP for complete financial statements. The September 30, 2018 consolidated balance sheet data were derived from audited financial statements but do not include all disclosures required by GAAP. However, except as disclosed herein, there has been no material change in the information disclosed in the notes to the consolidated financial statements for the year ended September 30, 2018 included in the Company’s Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on December 31, 2018. The interim unaudited condensed consolidated financial statements should be read in conjunction with those consolidated financial statements included in the Form 10-K. In the opinion of management, all adjustments considered necessary for a fair statement of the financial statements, consisting solely of normal recurring adjustments, have been made. Operating results for the three and six months ended March 31, 2019 are not necessarily indicative of the results that may be expected for the year ending September 30, 2019.

2. Recent Accounting Standards and Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, *Revenue from Contracts with Customers* (“ASU 2014-09” and codified as Accounting Standards Codification No. 606, “ASC 606”), which supersedes nearly all existing revenue recognition guidance under GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five-step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing GAAP. The standard’s effective date has been deferred by the issuance of ASU No. 2015-14, and is effective for annual periods beginning after December 15, 2017, and interim periods therein. The guidance permits using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or (ii) a retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). Early application is permitted but not before December 15, 2016, the ASU’s original effective date. The Company adopted the new revenue recognition standard as of October 1, 2018 using the cumulative effect method, which did not have a material impact on its consolidated financial statements. See Note 4 for new disclosures as required by ASC 606.

In January 2016, the FASB issued ASU No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, which amends the guidance on the classification and measurement of financial instruments. Although the ASU retains many current requirements, it significantly revises an entity’s accounting related to (1) the classification and measurement of investments in equity securities and (2) the presentation of certain fair value changes for financial liabilities measured at fair value. The ASU also amends certain disclosure requirements associated with the fair value of financial instruments. The amendments of the ASU are effective for us for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company adopted ASU 2016-01 as of October 1, 2018. Our adoption required the Company to reclassify \$220,000 from accumulated other comprehensive income to retained earnings as of the beginning of the quarter ended December 31, 2018. All succeeding unrealized gains or losses related the changes in the market value of our equity securities are included in non-operating gains/losses in our consolidated statement of income.

RCI HOSPITALITY HOLDINGS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*, on accounting for leases which requires lessees to recognize most leases on their balance sheets for the rights and obligations created by those leases. The guidance requires enhanced disclosures regarding the amount, timing, and uncertainty of cash flows arising from leases, and will be effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted. The guidance requires the use of a modified retrospective approach. We expect our consolidated balance sheets to be materially impacted upon adoption due to the recognition of right-of-use assets and lease liabilities related to currently classified operating leases. We are in the process of compiling an inventory of all lease documents and comparing them to recorded expenses to determine completeness. We have also evaluated several real estate leases according to the classification criteria of ASC 842. While we anticipate changes in the classification of expenses in our income statement and the timing of recognition of these expenses, we are still evaluating the materiality of the implementation of this standard.

In February 2018, the FASB issued ASU 2018-02, *Income Statement—Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*. This ASU provides financial statement preparers with an option to reclassify stranded tax effects within AOCI to retained earnings in each period in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act (“Tax Act”) is recorded. The ASU requires financial statement preparers to disclose (1) a description of the accounting policy for releasing income tax effects from AOCI; (2) whether they elect to reclassify the stranded income tax effects from the Tax Act; and (3) information about the other income tax effects that are reclassified. The amendments affect any organization that is required to apply the provisions of Topic 220, *Income Statement—Reporting Comprehensive Income*, and has items of other comprehensive income for which the related tax effects are presented in other comprehensive income as required by GAAP. The ASU is effective for all organizations for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. Organizations should apply the proposed amendments either in the period of adoption or retrospectively to each period (or periods) in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Act is recognized. We believe that the adoption of this ASU will not have a material impact on our consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement*. ASU 2018-13 modifies the disclosure requirements of Accounting Standards Codification (“ASC”) Topic 820 with certain removals, modifications, and additions. Eliminated disclosures that may affect the Company include (1) transfers between level 1 and level 2 of the fair value hierarchy, and (2) policies related to valuation processes and the timing of transfers between levels of the fair value hierarchy. Modified disclosures that may affect the Company include (1) a requirement to disclose the timing of liquidation of an investee’s assets and the date when restrictions from redemption might lapse if the entity has communicated the timing publicly for investments in certain entities that calculate net asset value, and (2) clarification that the measurement uncertainty disclosure is to communicate information about the uncertainty in measurement as of the reporting date. Additional disclosures that may affect the Company include (1) disclosure of changes in unrealized gains and losses for the period included in other comprehensive income for recurring level 3 fair value measurements held at the end of the reporting period, and (2) disclosure of the range and weighted average of significant unobservable inputs used to develop level 3 fair value measurements. The update is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early adoption is permitted for any removed or modified disclosures upon issuance of the ASU and delay adoption of the additional disclosures until the effective date. We are still evaluating the impact of this ASU on the Company’s consolidated financial statements.

RCI HOSPITALITY HOLDINGS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

In March 2019, the FASB issued ASU No. 2019-01, *Leases (Topic 842): Codification Improvements*. ASU 2019-01 aligns the guidance for fair value of the underlying asset by lessors with existing guidance in Topic 842. The ASU requires that the fair value of the underlying asset at lease commencement is its cost reflecting in volume or trade discounts that may apply. However, if there has been a significant lapse of time between the date the asset was acquired and the lease commencement date, the definition of fair value as outlined in Topic 820 should be applied. In addition, the ASU exempts both lessees and lessors from having to provide certain interim disclosures in the fiscal year in which a company adopts the new leases standard. The update is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. We are still evaluating the impact of this ASU on the Company's consolidated financial statements.

3. Revision of Prior Year Immaterial Misstatement

During the quarter ended December 31, 2018, the Company identified certain mechanical errors in our goodwill impairment analysis that was performed for our annual impairment testing for fiscal year ended September 30, 2018. These errors related to the use of an incorrect income tax rate assumption and the exclusion of certain debt service payments as part of our goodwill impairment testing for two of our reporting units, which resulted in a goodwill impairment charge of \$834,000.

The Company assessed the materiality of these errors considering both qualitative and quantitative factors and determined that for both the quarter and fiscal year ended September 30, 2018, the errors were immaterial. The Company has decided to correct these immaterial errors as revisions to our previously issued financial statements and will adjust the Form 10-K when filed in succeeding periods of this fiscal year.

The tables below present the impact of the revision in the Company's consolidated financial statements (in thousands):

| | Fiscal Year Ended September 30, 2018 | | |
|---|---|--------------------|-------------------|
| | As Previously Reported | Adjustments | As Revised |
| <i>Statement of Income/Comprehensive Income:</i> | | | |
| Other charges, net | \$ 8,350 | \$ 834 | \$ 9,184 |
| Total operating expenses | 137,352 | 834 | 138,186 |
| Income from operations | 28,396 | (834) | 27,562 |
| Income before income taxes | 18,676 | (834) | 17,842 |
| Net income | 21,794 | (834) | 20,960 |
| Net income attributable to RCIHH common stockholders | 21,713 | (834) | 20,879 |
| Earnings per share - basic | \$ 2.23 | \$ (0.08) | \$ 2.15 |
| Earnings per share - diluted | \$ 2.23 | \$ (0.08) | \$ 2.15 |
| Comprehensive income | \$ 22,014 | \$ (834) | \$ 21,180 |
| Comprehensive income attributable to RCI Hospitality Holdings, Inc. | 21,933 | (834) | 21,099 |

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| | September 30, 2018 | | |
|---|---------------------------|------------|------------|
| | As Previously Reported | Adjustment | As Revised |
| <i>Balance Sheet/Statement of Changes in Stockholders' Equity</i> | | | |
| Goodwill | \$ 44,425 | \$ (834) | \$ 43,591 |
| Total assets | 330,566 | (834) | 329,732 |
| Retained earnings | 89,740 | (834) | 88,906 |
| Total RCIHH stockholders' equity | 154,269 | (834) | 153,435 |
| Total stockholders' equity | 154,166 | (834) | 153,332 |
| Total liabilities and stockholders' equity | 330,566 | (834) | 329,732 |

The table below presents the impact of the revision in the Company's notes to its consolidated financial statements related to unaudited quarterly results of operations (in thousands):

| | Quarter Ended September 30, 2018 | | |
|--|----------------------------------|------------|------------|
| | As Previously Reported | Adjustment | As Revised |
| Income from operations | \$ 1,533 | \$ (834) | \$ 699 |
| Net loss attributable to RCIHH common stockholders | (2,672) | (834) | (3,506) |
| Loss per share - basic | \$ (0.27) | \$ (0.09) | \$ (0.36) |
| Loss per share - diluted | \$ (0.27) | \$ (0.09) | \$ (0.36) |

The consolidated statements of cash flows are not presented because there is no impact on total cash flows from operating activities, investing activities and financing activities. Certain components of net cash provided by operating activities changed, as caused by the revision, but the net change amounted to zero for both quarter and fiscal year ended September 30, 2018.

4. Revenues

On October 1, 2018, the Company adopted ASC Topic 606, *Revenue from Contracts with Customers* (formerly ASU 2014-09). The Company recognizes revenue from the sale of alcoholic beverages, food and merchandise, service and other revenues at the point-of-sale upon receipt of cash, check, or credit card charge, net of discounts and promotional allowances based on consideration specified in implied contracts with customers. Sales and liquor taxes collected from customers and remitted to governmental authorities are presented on a net basis in the unaudited condensed accompanying consolidated statements of income. The Company recognizes revenue when it satisfies a performance obligation (point in time of sale) by transferring control over a product or service to a customer.

Commission revenues, such as ATM commission, are recognized when the basis for such commission has transpired. Revenues from the sale of magazines and advertising content are recognized when the issue is published and shipped. Revenues and external expenses related to the Company's annual Expo convention are recognized upon the completion of the convention, which normally occurs during our fiscal fourth quarter. Other rental revenues are recognized when earned (recognized over time) and are more appropriately covered by guidance under ASC Topic 840, *Leases*.

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Revenues, as disaggregated by revenue type, timing of recognition, and reportable segment (see also Note 11), are shown below.

| | Three Months Ended March 31, 2019 | | | | Three Months Ended March 31, 2018 | | | |
|-------------------------------|-----------------------------------|-----------------|---------------|------------------|-----------------------------------|-----------------|---------------|------------------|
| | Nightclubs | Bombshells | Other | Total | Nightclubs | Bombshells | Other | Total |
| Sales of alcoholic beverages | \$ 14,148 | \$ 4,338 | \$ - | \$ 18,486 | \$ 13,992 | \$ 3,380 | \$ - | \$ 17,372 |
| Sales of food and merchandise | 3,293 | 3,146 | - | 6,439 | 3,208 | 2,216 | - | 5,424 |
| Service revenues | 16,943 | 36 | - | 16,979 | 16,133 | - | - | 16,133 |
| Other revenues | 2,663 | 7 | 252 | 2,922 | 2,110 | 6 | 181 | 2,297 |
| | <u>\$ 37,047</u> | <u>\$ 7,527</u> | <u>\$ 252</u> | <u>\$ 44,826</u> | <u>\$ 35,443</u> | <u>\$ 5,602</u> | <u>\$ 181</u> | <u>\$ 41,226</u> |
| Recognized at a point in time | \$ 36,582 | \$ 7,527 | \$ 238 | \$ 44,347 | \$ 35,152 | \$ 5,602 | \$ 163 | \$ 40,917 |
| Recognized over time | 465* | - | 14 | 479 | 291* | - | 18 | 309 |
| | <u>\$ 37,047</u> | <u>\$ 7,527</u> | <u>\$ 252</u> | <u>\$ 44,826</u> | <u>\$ 35,443</u> | <u>\$ 5,602</u> | <u>\$ 181</u> | <u>\$ 41,226</u> |

| | Six Months Ended March 31, 2019 | | | | Six Months Ended March 31, 2018 | | | |
|-------------------------------|---------------------------------|------------------|---------------|------------------|---------------------------------|------------------|---------------|------------------|
| | Nightclubs | Bombshells | Other | Total | Nightclubs | Bombshells | Other | Total |
| Sales of alcoholic beverages | \$ 28,950 | \$ 7,846 | \$ - | \$ 36,796 | \$ 28,117 | \$ 7,060 | \$ - | \$ 35,177 |
| Sales of food and merchandise | 6,500 | 5,629 | - | 12,129 | 6,370 | 4,361 | - | 10,731 |
| Service revenues | 34,256 | 54 | - | 34,310 | 32,022 | - | - | 32,022 |
| Other revenues | 5,069 | 11 | 534 | 5,614 | 4,152 | 9 | 347 | 4,508 |
| | <u>\$ 74,775</u> | <u>\$ 13,540</u> | <u>\$ 534</u> | <u>\$ 88,849</u> | <u>\$ 70,661</u> | <u>\$ 11,430</u> | <u>\$ 347</u> | <u>\$ 82,438</u> |
| Recognized at a point in time | \$ 73,974 | \$ 13,540 | \$ 505 | \$ 88,019 | \$ 70,079 | \$ 11,430 | \$ 308 | \$ 81,817 |
| Recognized over time | 801* | - | 29 | 830 | 582* | - | 39 | 621 |
| | <u>\$ 74,775</u> | <u>\$ 13,540</u> | <u>\$ 534</u> | <u>\$ 88,849</u> | <u>\$ 70,661</u> | <u>\$ 11,430</u> | <u>\$ 347</u> | <u>\$ 82,438</u> |

* Rental revenue (included in Other Revenues) as covered by ASC Topic 840. All other revenues are covered by ASC Topic 606.

The Company does not have contract assets with customers. The Company's unconditional right to consideration for goods and services transferred to the customer is included in accounts receivable, net in our unaudited condensed consolidated balance sheet. A reconciliation of contract liabilities with customers is presented below:

| | Balance at September 30, 2018 | Consideration Received | Recognized in Revenue | Balance at March 31, 2019 |
|--------------|----------------------------------|------------------------|-----------------------|------------------------------|
| Ad revenue | \$ 126 | \$ 374 | \$ (311) | \$ 189 |
| Expo revenue | - | 357 | (2) | 355 |
| Other | 8 | 33 | (29) | 12 |
| | <u>\$ 134</u> | <u>\$ 764</u> | <u>\$ (342)</u> | <u>\$ 556</u> |

Contract liabilities with customers are included in accrued liabilities as unearned revenues in our unaudited condensed consolidated balance sheets (see also Note 5), while the revenues associated with these contract liabilities are included in other revenues in our unaudited condensed consolidated statements of income.

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5. Selected Account Information

The components of accrued liabilities are as follows (in thousands):

| | <u>March 31, 2019</u> | <u>September 30, 2018</u> |
|---------------------------|-----------------------|---------------------------|
| Payroll and related costs | \$ 2,782 | \$ 2,293 |
| Sales and liquor taxes | 2,009 | 1,883 |
| Insurance | 1,344 | 3,807 |
| Property taxes | 890 | 1,796 |
| Patron tax | 617 | 532 |
| Unearned revenues | 556 | 134 |
| Income taxes | 363 | - |
| Lawsuit settlements | 75 | 230 |
| Other | 1,275 | 1,298 |
| | <u>\$ 9,911</u> | <u>\$ 11,973</u> |

The components of selling, general and administrative expenses are as follows (in thousands):

| | <u>For the Three Months Ended March 31,</u> | | <u>For the Six Months Ended March 31,</u> | |
|----------------------------------|---|------------------|---|------------------|
| | <u>2019</u> | <u>2018</u> | <u>2019</u> | <u>2018</u> |
| Taxes and permits | \$ 2,370 | \$ 2,005 | \$ 4,551 | \$ 4,171 |
| Advertising and marketing | 2,070 | 1,837 | 4,218 | 3,802 |
| Supplies and services | 1,465 | 1,315 | 2,921 | 2,683 |
| Insurance | 1,402 | 1,368 | 2,755 | 2,627 |
| Accounting and professional fees | 1,278 | 670 | 1,928 | 1,556 |
| Rent | 957 | 957 | 1,976 | 1,897 |
| Charge card fees | 886 | 784 | 1,819 | 1,671 |
| Legal | 773 | 1,009 | 1,831 | 1,386 |
| Utilities | 762 | 738 | 1,506 | 1,433 |
| Security | 756 | 632 | 1,465 | 1,270 |
| Repairs and maintenance | 721 | 521 | 1,308 | 1,091 |
| Other | 901 | 1,012 | 2,090 | 2,073 |
| | <u>\$ 14,341</u> | <u>\$ 12,848</u> | <u>\$ 28,368</u> | <u>\$ 25,660</u> |

6. Long-Term Debt

On November 1, 2018, the Company raised \$2.35 million through the issuance of 12% unsecured promissory notes to certain investors, which notes mature on November 1, 2021. The notes pay interest-only in equal monthly installments, with a lump sum principal payment at maturity. Among the promissory notes are two notes with a principal of \$450,000 and \$200,000. The \$450,000 note was in exchange for a \$300,000 12% note and the \$200,000 note was in exchange for a \$100,000 note, both of which were included in the May 1, 2017 financing to acquire Scarlett's Cabaret in Miami. Also included in the \$2.35 million borrowing is a \$500,000 note borrowed from a related party (see Note 13) and two notes totaling \$400,000 borrowed from a non-officer employee and a family member of a non-officer employee in which the terms of the notes are the same as the rest of the lender group.

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On December 6, 2018, the Company amended the \$5.0 million short-term note payable related to the Scarlett's acquisition, which had a remaining balance of \$3.0 million as of December 6, 2018, extending the maturity date from May 8, 2019, as previously amended, to May 8, 2020.

On December 11, 2018, the Company purchased an aircraft for \$2.8 million with a \$554,000 down payment and financed the remaining \$2.2 million with a 5.49% promissory note payable in 20 years with monthly payments of \$15,118, including interest.

On February 8, 2019, the Company refinanced a one-year bank note with a balance of \$1.5 million, bearing an interest rate of 6.1%, with a construction loan with another bank, which has an interest rate of 6.0% adjusted after five years to prime plus 0.5% with a 6.0% floor per annum. The new construction loan, which has a maximum availability of \$4.1 million, matures in 252 months from closing date and is payable interest-only for the first 12 months, then principal and interest of \$29,571 monthly for the next 48 months, and the remaining term monthly payments of principal and interest based on the adjusted interest rate. The Company paid approximately \$69,000 in loan costs of which approximately \$19,600 was capitalized as debt issuance costs on the new construction loan with the remaining charged to interest expense. The Company also wrote off the remaining unamortized debt issuance costs of the old bank note to interest expense.

Included in the balance of long-term debt as of March 31, 2019 and September 30, 2018 is a \$200,000 note, that is a part of the May 1, 2017 financing, borrowed from a non-officer employee in which the terms of the note are the same as the rest of the lender group.

Future maturities of long-term debt are as follows: \$10.4 million, \$17.9 million, \$19.3 million, \$8.2 million, \$8.9 million and \$86.7 million for the twelve months ending March 31, 2020, 2021, 2022, 2023, 2024, and thereafter, respectively. Of the maturity schedule mentioned above, \$0, \$9.2 million, \$10.6 million, \$651,000, \$1.3 million and \$39.7 million, respectively, relate to scheduled balloon payments.

7. Stockholders' Equity

During the three and six months ended March 31, 2019, the Company purchased and retired 70,700 and 84,811 common shares, respectively, at a cost of approximately \$1.6 million and \$2.0 million, respectively. The Company paid a \$0.03 per share cash dividend per quarter totaling approximately \$291,000 and \$582,000 for the three and six months ended March 31, 2019, respectively.

During the three and six months ended March 31, 2018, the Company did not purchase shares of its common stock. The Company also paid a \$0.03 per share cash dividend per quarter totaling approximately \$291,000 and \$583,000 for the three and six months ended March 31, 2018, respectively.

On January 2, 2019, the Company's Board of Directors authorized an additional \$10.0 million to repurchase the Company's common stock. As of March 31, 2019, we have \$11.2 million remaining to purchase additional shares under our share repurchase program.

8. Earnings Per Share

Basic earnings per share ("EPS") includes no dilution and is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflect the potential dilution of securities that could share in the earnings of the Company. Potential common stock shares consist of shares that may arise from outstanding dilutive common restricted stock, stock options and warrants (the number of which is computed using the "treasury stock method") and from outstanding convertible debentures (the number of which is computed using the "if converted method"). Diluted EPS considers the potential dilution that could occur if the Company's outstanding common restricted stock, stock options, warrants and convertible debentures were converted into common stock that then shared in the Company's earnings (as adjusted for interest expense that would no longer occur if the debentures were converted).

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During the three and six months ended March 31, 2019 and 2018, the Company did not have any outstanding dilutive securities that are considered adjustment items to reconcile the numerator and the denominator in the calculation of basic and diluted EPS.

9. Income Taxes

Income taxes were an expense of \$1.9 million and \$3.7 million during the three and six months ended March 31, 2019, respectively, compared to an expense of \$1.5 million and a benefit of \$6.7 million during the three and six months ended March 31, 2018, respectively. The effective income tax rate for the three and six months ended March 31, 2019 was an expense of 22.3% and 22.2%, respectively, compared to an expense of 24.2% and a benefit of 54.6% for the three and six months ended March 31, 2018, respectively. Our effective tax rate is affected by state taxes, permanent differences, and tax credits, including the FICA tip credit, for both years while the first quarter of 2018 was significantly impacted by a \$9.7 million reduction of our deferred tax liability caused by then-enacted tax laws (see below).

The Tax Cuts and Jobs Act (“Tax Act”) was enacted on December 22, 2017, and includes, among other items, a reduction in the federal corporate income tax rate from 35% to 21% effective January 1, 2018. Our federal corporate income tax rate for fiscal 2018 was 24.5% percent and represents a blended income tax rate for our fiscal year ended September 30, 2018. For fiscal 2019, our federal corporate income tax rate is 21%.

Additionally, for the fiscal year ended September 30, 2018, in accordance with FASB ASC Topic 740, we remeasured our deferred tax balances to reflect the reduced rate that will apply when these deferred taxes are settled or realized in future periods. The remeasurement resulted in a \$8.7 million full year adjustment of our net deferred tax liabilities reflected in our consolidated balance sheet as of September 30, 2018 and a corresponding income tax benefit reflected in our consolidated statements of income for the fiscal year ended September 30, 2018. The SEC staff issued Staff Accounting Bulletin No. 118, which allows companies to record provisional amounts during a measurement period that is similar to the measurement period used when accounting for business combinations. There were no additional measurement adjustments since September 30, 2018 until the end of the measurement period on December 22, 2018.

Under generally accepted accounting principles, the Company uses the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. At September 30, 2017, the Company’s deferred tax assets and liabilities were determined based on the then-current enacted federal tax rate of 35%. As a result of the reduction in the corporate income tax rate under the Tax Act, the Company revalued its deferred tax assets and liabilities at December 31, 2017. Deferred tax assets and liabilities expected to be realized in fiscal year 2018 were re-measured using the aforementioned blended rate. All remaining deferred tax assets and liabilities were re-measured using the new statutory federal rate of 21%.

The Company or one of its subsidiaries files income tax returns for U.S. federal jurisdiction and various states. Fiscal years ended September 30, 2016 and thereafter remain open to tax examination. The Company’s federal income tax returns for the years ended September 30, 2015, 2014 and 2013 have been examined by the Internal Revenue Service with no changes. These years are now under examination for payroll taxes. The Company is also being examined for state income taxes, the outcome of which may occur within the next twelve months.

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The Company accounts for uncertain tax positions pursuant to ASC Topic 740, *Income Taxes*. As of March 31, 2019 and September 30, 2018, the liability for uncertain tax positions totaled approximately \$165,000 as of each date, which is included in current liabilities on our condensed consolidated balance sheets. The Company recognizes interest accrued related to uncertain tax positions in interest expense and penalties in selling, general and administrative expenses in our consolidated statements of income.

10. Commitments and Contingencies

Legal Matters

Texas Patron Tax

In 2015, the Company reached a settlement with the State of Texas over the payment of the state's Patron Tax on adult club customers. To resolve the issue of taxes owed, the Company agreed to pay \$10.0 million in equal monthly installments of \$119,000, without interest, over 84 months, beginning in June 2015, for all but two non-settled locations. The Company agreed to remit the Patron Tax on a monthly basis, based on the current rate of \$5 per customer. For accounting purposes, the Company has discounted the \$10.0 million at an imputed interest rate of 9.6%, establishing a net present value for the settlement of \$7.2 million. As a consequence, the Company has recorded an \$8.2 million pre-tax gain for the third quarter ended June 30, 2015, representing the difference between the \$7.2 million and the amount previously accrued for the tax.

In March 2017, the Company settled with the State of Texas for one of the two remaining unsettled Patron Tax locations. To resolve the issue of taxes owed, the Company agreed to pay a total of \$687,815 with \$195,815 paid at the time the settlement agreement was executed followed by 60 equal monthly installments of \$8,200 without interest. The Company believes that it does not have any further liability related to the other location.

The aggregate balance of Patron Tax settlement liability, which is included in long-term debt in the consolidated balance sheets, amounted to \$3.9 million and \$4.5 million as of March 31, 2019 and September 30, 2018, respectively.

A Declaratory judgment action was brought by five operating subsidiaries of the Company in state court, to challenge a Texas Comptroller administrative rule related to the \$5 per customer Patron Tax Fee assessed against Sexually Oriented Businesses. An administrative rule attempted to expand the fee to cover venues featuring dancers using latex cover as well as traditional nude entertainment. The administrative rule was challenged on both constitutional and statutory grounds. On November 19, 2018, the Court issued an order that a key aspect of the administrative rule is invalid based on it exceeding the scope of the Comptroller's authority. Other challenges remain and will be resolved at trial. In addition to the foregoing state court lawsuit, the Texas Entertainment Association filed a federal lawsuit against the Comptroller challenging the constitutionality of the administrative rule. On February 27, 2019, the Court ruled on summary judgment motions filed by the parties. The Court ruled that the amended rule was an unconstitutional restriction on expressive conduct under the First Amendment of the U.S. Constitution, unconstitutionally retroactive under the Due Process Clause and violated the provisions of 42 U.S.C. §1983. There are remaining claims and defenses pending with the Court.

Indemnity Insurance Corporation

As previously reported, the Company and its subsidiaries were insured under a liability policy issued by Indemnity Insurance Corporation, RRG ("IIC") through October 25, 2013. The Company and its subsidiaries changed insurance companies on that date.

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On November 7, 2013, the Court of Chancery of the State of Delaware entered a Rehabilitation and Injunction Order (“Rehabilitation Order”), which declared IIC impaired, insolvent and in an unsafe condition and placed IIC under the supervision of the Insurance Commissioner of the State of Delaware (“Commissioner”) in her capacity as receiver (“Receiver”). The Rehabilitation Order empowered the Commissioner to rehabilitate IIC through a variety of means, including gathering assets and marshaling those assets as necessary. Further, the order stayed or abated pending lawsuits involving IIC as the insurer until May 6, 2014.

On April 10, 2014, the Court of Chancery of the State of Delaware entered a Liquidation and Injunction Order With Bar Date (“Liquidation Order”), which ordered the liquidation of IIC and terminated all insurance policies or contracts of insurance issued by IIC. The Liquidation Order further ordered that all claims against IIC must be filed with the Receiver before the close of business on January 16, 2015 and that all pending lawsuits involving IIC as the insurer are further stayed or abated until October 7, 2014. As a result, the Company and its subsidiaries no longer have insurance coverage under the liability policy with IIC. The Company has retained counsel to defend against and evaluate these claims and lawsuits. We are funding 100% of the costs of litigation and will seek reimbursement from the bankruptcy receiver. The Company filed the appropriate claims against IIC with the Receiver before the January 16, 2015 deadline and has provided updates as requested; however, there are no assurances of any recovery from these claims. It is unknown at this time what effect this uncertainty will have on the Company. As previously stated, since October 25, 2013, the Company has obtained general liability coverage from other insurers, which have covered and/or will cover any claims arising from actions after that date. As of March 31, 2019, we have 2 unresolved claims out of the original 71 claims.

Shareholder Class and Derivative Actions

In May and June 2019, three putative securities class action complaints were filed against RCI Hospitality Holdings, Inc. and certain of its officers in the Southern District of Texas, Houston Division. The complaints allege violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and 10b-5 promulgated thereunder based on alleged materially false and misleading statements made in the Company’s SEC filings and disclosures as they relate to various alleged transactions by the Company and management. The complaints seek unspecified damages, costs, and attorneys’ fees. These lawsuits are *Hoffman v. RCI Hospitality Holdings, Inc., et al.* (filed May 21, 2019, naming the Company and Eric Langan); *Gu v. RCI Hospitality Holdings, Inc., et al.* (filed May 28, 2019, naming the Company, Eric Langan, and Phil Marshall); and *Grossman v. RCI Hospitality Holdings, Inc., et al.* (filed June 28, 2019, naming the Company, Eric Langan, and Phil Marshall). The plaintiffs in all three cases have moved to consolidate the purported class actions. The Company anticipates a consolidated class action complaint will be filed in the next few months. The Company intends to vigorously defend against these actions. These actions are in their preliminary phases, and a potential loss cannot yet be estimated.

On August 16, 2019, a shareholder derivative action was filed in the Southern District of Texas, Houston Division against officers and directors, Eric S. Langan, Phillip Marshall, Nour-Dean Anakar, Yura Barabash, Steven Jenkins, Luke Lirot, Travis Reese and RCI Hospitality Holdings, Inc., as nominal defendant. The action alleges that the individual officers and directors made or caused the Company to make a series of materially false and/or misleading statements and omissions regarding the Company’s business, operations, prospects, and legal compliance and engaged in or caused the Company to engage in, inter alia, related party transactions, questionable uses of corporate assets, and failure to maintain internal controls. The action asserts claims for breach of fiduciary duty, unjust enrichment, abuse of control, gross mismanagement, waste of corporate assets, and violations of Sections 14(a), 10(b) and 20(a) of the Securities Exchange Act of 1934. The complaint seeks injunctive relief, damages, restitution, costs, and attorneys’ fees. The case, *Cecere v. Langan, et al.*, is in its early stage, and a potential loss cannot yet be estimated.

SEC Matter and Internal Review

In mid- and late 2018, a series of negative articles about the Company was anonymously published in forums associated with the short-selling community. Subsequently in 2019, the SEC initiated an informal inquiry. In connection with these events, a special committee of the Company’s audit committee engaged independent outside counsel to conduct an internal review. Management of the Company fully cooperated with the internal review conducted by the special committee and its outside counsel. The board of directors is implementing the recommendations resulting from the internal review. As of the date hereof, the internal review has been completed subject to any ongoing cooperation with regulatory authorities.

Since the initiation of the informal inquiry by the SEC in early 2019, the Company and its management have fully cooperated and continue to fully cooperate with the SEC matter, which has now converted to a formal investigation and is ongoing. At this time, the Company is unable to predict the duration, scope, result or related costs associated with the investigation. The Company is also unable to predict what, if any, action may be taken as a result of the investigation. Any determination by the SEC that the Company’s activities were not in compliance with federal securities laws or regulations, however, could result in the imposition of fines, penalties, disgorgement, or equitable relief, which could have a material adverse effect on the Company.

Other

On March 26, 2016, an image infringement lawsuit was filed in federal court in the Southern District of New York against the Company and several of its subsidiaries. Plaintiffs allege that their images were misappropriated, intentionally altered and published without their consent by clubs affiliated with the Company. The causes of action asserted in Plaintiffs’ Complaint include alleged violations of the Federal Lanham Act, the New York Civil Rights Act, and other statutory and common law theories. The Company contends that there is insurance coverage under an applicable insurance policy. The insurer has raised several issues regarding coverage under the policy. At this time, this disagreement remains unresolved. The Company has denied all allegations, continues to vigorously defend against the lawsuit and continues to believe the matter is covered by insurance.

The Company has been sued by a landlord in the 333rd Judicial District Court of Harris County, Texas for a Houston Bombshells which was under renovation in 2015. The plaintiff alleges RCI Hospitality Holdings, Inc.’s subsidiary, BMB Dining Services (Willowbrook), Inc., breached a lease agreement by constructing an outdoor patio, which allegedly interfered with the common areas of the shopping center, and by failing to provide Plaintiff with proposed plans before beginning construction. Plaintiff also asserts RCI Hospitality Holdings, Inc. is liable as guarantor of the lease. The lease was for a Bombshells restaurant to be opened in the Willowbrook Shopping Center in Houston, Texas. Both RCI Hospitality Holdings, Inc. and BMB Dining Services (Willowbrook), Inc. have denied liability and

assert that Plaintiff has failed to mitigate its claimed damages. Further, BMB Dining Services (Willowbrook), Inc. asserts that Plaintiff affirmatively represented that the patio could be constructed under the lease and has filed counter claims and third-party claims against Plaintiff and Plaintiff's manager asserting that they committed fraud and that the landlord breached the applicable agreements. The case was tried to a jury in late September 2018 and an adverse judgment was entered in January 2019 in the amount totaling \$1.0 million, which includes damages, attorney fees and interest. The matter is being appealed. The appeal process required that a check be deposited in the registry of the court in the amount of \$690,000, which was deposited in April 2019. Management believes that the case has no merit and is vigorously defending itself in the appeal.

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On June 23, 2014, Mark H. Dupray and Ashlee Dupray filed a lawsuit against Pedro Antonio Panameno and our subsidiary JAI Dining Services (Phoenix) Inc. (“JAI Phoenix”) in the Superior Court of Arizona for Maricopa County. The suit alleged that Mr. Panameno injured Mr. Dupray in a traffic accident after being served alcohol at an establishment operated by JAI Phoenix. The suit alleged that JAI Phoenix was liable under theories of common law dram shop negligence and dram shop negligence per se. After a jury trial proceeded to a verdict in favor of the plaintiffs against both defendants, in April 2017 the Court entered a judgment under which JAI Phoenix’s share of compensatory damages is approximately \$1.4 million and its share of punitive damages is \$4 million. In May 2017, JAI Phoenix filed a motion for judgment as a matter of law or, in the alternative, motion for new trial. The Court denied this motion in August 2017. In September 2017, JAI Phoenix filed a notice of appeal. In June 2018, the matter was heard by the Arizona Court of Appeals. On November 15, 2018 the Court of Appeals vacated the jury’s verdict and remanded the case to the trial court. The Plaintiffs have filed a petition for review with the Arizona Supreme Court. JAI Phoenix has filed a response and will continue to vigorously defend itself.

As set forth in the risk factors as disclosed in the Company’s Annual Report on Form 10-K for the fiscal year ended September 30, 2018, the adult entertainment industry standard is to classify adult entertainers as independent contractors, not employees. While we take steps to ensure that our adult entertainers are deemed independent contractors, from time to time, we are named in lawsuits related to the alleged misclassification of entertainers. Claims are brought under both federal and where applicable, state law. Based on the industry standard, the manner in which the independent contractor entertainers are treated at the clubs, and the entertainer license agreements governing the entertainer’s work at the clubs, the Company believes that these lawsuits are without merit. Lawsuits are handled by attorneys with an expertise in the relevant law and are defended vigorously.

General

In the regular course of business affairs and operations, we are subject to possible loss contingencies arising from third-party litigation and federal, state, and local environmental, labor, health and safety laws and regulations. We assess the probability that we could incur liability in connection with certain of these lawsuits. Our assessments are made in accordance with generally accepted accounting principles, as codified in ASC 450-20, and is not an admission of any liability on the part of the Company or any of its subsidiaries. In certain cases that are in the early stages and in light of the uncertainties surrounding them, we do not currently possess sufficient information to determine a range of reasonably possible liability. In matters where there is insurance coverage, in the event we incur any liability, we believe it is unlikely we would incur losses in connection with these claims in excess of our insurance coverage.

Settlements of lawsuits for the three and six months ended March 31, 2019 total \$84,000 and \$144,000, respectively, while for the three and six months ended March 31, 2018 total \$773,000 and \$800,000, respectively. As of March 31, 2019 or September 30, 2018, the Company has accrued \$75,000 and \$230,000 in accrued liabilities, respectively, related to settlement of lawsuits.

11. Segment Information

The Company owns and operates adult nightclubs and Bombshells Restaurants and Bars. The Company has identified such reportable segments based on management responsibility and the nature of the Company’s products, services, and costs. There are no major distinctions in geographical areas served as all operations are in the United States. The Company measures segment profit (loss) as income (loss) from operations. Segment assets are those assets controlled by each reportable segment. The Other category below includes our media and energy drink divisions that are not significant to the consolidated financial statements.

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Below is the financial information related to the Company's segments (in thousands):

| | For the Three Months Ended March 31, | | For the Six Months Ended March 31, | |
|--------------------------------------|---|-----------------------|---------------------------------------|---------------------------|
| | 2019 | 2018 | 2019 | 2018 |
| Revenues | | | | |
| Nightclubs | \$ 37,047 | \$ 35,443 | \$ 74,775 | \$ 70,661 |
| Bombshells | 7,527 | 5,602 | 13,540 | 11,430 |
| Other | 252 | 181 | 534 | 347 |
| | <u>\$ 44,826</u> | <u>\$ 41,226</u> | <u>\$ 88,849</u> | <u>\$ 82,438</u> |
| Income (loss) from operations | | | | |
| Nightclubs | \$ 15,078 | \$ 11,880 | \$ 30,465 | \$ 25,251 |
| Bombshells | 738 | 965 | 857 | 1,856 |
| Other | (176) | (82) | (295) | (219) |
| General corporate | (4,474) | (4,532) | (8,729) | (9,517) |
| | <u>\$ 11,166</u> | <u>\$ 8,231</u> | <u>\$ 22,298</u> | <u>\$ 17,371</u> |
| Depreciation and amortization | | | | |
| Nightclubs | \$ 1,467 | \$ 1,334 | \$ 2,974 | \$ 2,669 |
| Bombshells | 339 | 341 | 631 | 677 |
| Other | 106 | (29) | 210 | (27) |
| General corporate | 288 | 253 | 438 | 489 |
| | <u>\$ 2,200</u> | <u>\$ 1,899</u> | <u>\$ 4,253</u> | <u>\$ 3,808</u> |
| Capital expenditures | | | | |
| Nightclubs | \$ 647 | \$ 847 | \$ 1,094 | \$ 1,297 |
| Bombshells | 5,788 | 5,272 | 9,797 | 7,500 |
| Other | 9 | 4 | 18 | 4 |
| General corporate | 163 | 119 | 2,993 | 210 |
| | <u>\$ 6,607</u> | <u>\$ 6,242</u> | <u>\$ 13,902</u> | <u>\$ 9,011</u> |
| | | March 31, 2019 | | September 30, 2018 |
| Total assets | | | | |
| Nightclubs | \$ | 277,209 | \$ | 252,335 |
| Bombshells | | 39,455 | | 39,560 |
| Other | | 2,178 | | 1,978 |
| General corporate | | 32,031 | | 35,859 |
| | <u>\$</u> | <u>350,873</u> | <u>\$</u> | <u>329,732</u> |

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General corporate expenses include corporate salaries, health insurance and social security taxes for officers, legal, accounting and information technology employees, corporate taxes and insurance, legal and accounting fees, depreciation and other corporate costs such as automobile and travel costs. Management considers these to be non-allocable costs for segment purposes.

Certain real estate assets previously wholly assigned to Bombshells have been subdivided and allocated to other future development or investment projects. Accordingly, those asset costs have been transferred out of the Bombshells segment.

12. Noncontrolling Interests

Noncontrolling interests represent the portion of equity in a consolidated entity held by owners other than the consolidating parent. Noncontrolling interests are reported in the consolidated balance sheets within equity, separately from stockholders' equity. Revenue, expenses and net income attributable to both the Company and the noncontrolling interests are reported in the consolidated statements of income.

Our consolidated financial statements include noncontrolling interests related principally to the Company's ownership of 51% of an entity which owns one of the Company's nightclubs in New York City.

13. Related Party Transactions

Presently, our Chairman and President, Eric Langan, personally guarantees all of the commercial bank indebtedness of the Company. Mr. Langan receives no compensation or other direct financial benefit for any of the guarantees. The balance of our commercial bank indebtedness, net of debt discount and issuance costs, as of March 31, 2019 and September 30, 2018 is \$90.8 million and \$88.9 million, respectively.

Included in the \$2.35 million borrowing on November 1, 2018 (see Note 6) was a \$500,000 note borrowed from a related party (Ed Anakar, an employee of the Company and brother of our director Nourdean Anakar). The terms of this related party note are the same as the rest of the lender group in the November 1, 2018 transaction.

We used the services of Sherwood Forest Creations, LLC, a furniture fabrication company that manufactures tables, chairs and other furnishings for our Bombshells locations, as well as providing ongoing maintenance. Sherwood Forest is owned by a brother of Eric Langan. Amounts billed to us for goods and services provided by Sherwood Forest were \$98,072 and \$107,815 during the three and six months ended March 31, 2019, respectively, and \$17,233 and \$114,561 during the three and six months ended March 31, 2018, respectively. As of March 31, 2019 and September 30, 2018, we owed Sherwood Forest \$49,258 and \$73,377, respectively, in unpaid billings.

TW Mechanical LLC ("TW Mechanical") provided plumbing and HVAC services to both a third-party general contractor providing construction services to the Company, as well as directly to the Company during fiscal 2018 and 2019. TW Mechanical is 20% owned by the son-in-law of Eric Langan. Amounts billed by TW Mechanical to the third-party general contractor were \$359,500 and \$435,800 for the three and six months ended March 31, 2019, respectively, and \$0 and \$0 for the three and six months ended March 31, 2018, respectively. Amounts billed directly to the Company were \$206 and \$206 for the three and six months ended March 31, 2019, respectively, and \$0 and \$0 for the three and six months ended March 31, 2018, respectively. As of March 31, 2019 and September 30, 2018, we owed TW Mechanical \$0 and \$0, respectively, in unpaid direct billings.

14. Acquisitions and Disposition

In October 2018, the Company sold its nightclub in Philadelphia for a total sales price of \$1.0 million, payable \$375,000 in cash at closing and a \$625,000 9% note receivable over a 10-year period. The note is payable interest-only for twelve months at the conclusion of which time a balloon payment of \$250,000 is due, and then the remainder of the principal and interest is payable in 108 equal installments of \$5,078 per month until October 2028. The buyer will lease the property from the Company's real estate subsidiary under the following terms: \$36,000 per month lease payments for ten years; renewal option for a succeeding ten years at a minimum of \$48,000 per month; lessee has option to purchase the property for \$6.0 million during a term beginning November 2023 and expiring in October 2028. The Company recorded a gain on the sale transaction of approximately \$879,000, which is included in other charges (gains), net in our consolidated statement of income during the quarter ended December 31, 2018. In July 2019, the Company and the buyer agreed to modify the promissory note to include in principal (i) rental payments from April to September 2019, (ii) accrued property taxes, (iii) accrued occupancy taxes, and (iv) two months of outstanding interest payments for a total principal balance of \$879,085. The note, as modified, still bears interest at 9% and is payable in 108 equal monthly installments of \$11,905, including principal and interest, until July 2028.

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On November 1, 2018, a club in Chicago was acquired for \$10.5 million with \$6.0 million cash paid at closing and the \$4.5 million in a 6-year seller financed note with interest at 7%. The Company paid approximately \$37,000 in acquisition-related costs for this transaction, which is included in selling, general and administrative expenses in our unaudited condensed consolidated statement of income. The club generated revenue of approximately \$1.8 million since acquisition date. In relation to this acquisition, on September 25, 2018, the Company borrowed \$5.0 million through a credit facility with a bank lender. The loan has a 7% fixed interest rate and matures in May 2019. The loan was payable \$200,000 weekly, which included interest, until maturity. The loan was fully paid as of June 30, 2019. Goodwill and SOB license for the Chicago acquisition will not be amortized but will be tested at least annually for impairment. Goodwill recognized for this transaction is not deductible for tax purposes. Noncompete will be amortized on a straight-line basis over five years from acquisition date.

The following information summarizes the preliminary allocation of fair values assigned to the assets at acquisition date (in thousands):

| | | |
|-------------------------|----|---------------|
| Land and building | \$ | 4,325 |
| Inventory | | 57 |
| Furniture and equipment | | 50 |
| Noncompete | | 100 |
| SOB license | | 5,252 |
| Goodwill | | 2,003 |
| Deferred tax liability | | (1,287) |
| Net assets | \$ | <u>10,500</u> |

On November 5, 2018, a Pittsburgh club was acquired for \$15.0 million, with \$7.5 million cash paid at closing and two seller notes payable. The first note is 2-year 7% note for \$2.0 million, and the second is a 10-year 8% note for \$5.5 million. The Company paid acquisition-related costs for this transaction of approximately \$134,000, which is included in selling, general and administrative expenses in our unaudited condensed consolidated statement of income. The club generated revenue of approximately \$2.1 million since acquisition date. Goodwill for the Pittsburgh acquisition will not be amortized but will be tested at least annually for impairment. Goodwill recognized for this transaction is deductible for tax purposes. Noncompete will be amortized on a straight-line basis over five years from acquisition date.

The following information summarizes the preliminary allocation of fair values assigned to the assets at acquisition date (in thousands):

| | | |
|-------------------------|----|---------------|
| Land and building | \$ | 5,000 |
| Inventory | | 23 |
| Furniture and equipment | | 200 |
| Noncompete | | 100 |
| Goodwill | | 9,677 |
| Net assets | \$ | <u>15,000</u> |

It is management's expectation that the purchase price of these acquisitions will be allocated to assets, including land, buildings, inventory, noncompetes, SOB license, and goodwill; however, the final purchase price allocation of the two clubs remains subject to post-closing adjustments until the Company has completed final valuation and accounting for the transactions.

In November 2018, the Company sold two assets held for sale in Houston and San Antonio, Texas for a combined sales price of \$868,000. Net gain on the two transactions amounted to \$273,000 after closing costs. The Company used \$945,500 of the proceeds to pay down loans related to the properties.

On January 24, 2019, the Company sold a held-for-sale property in Dallas, Texas for a total sales price of \$1.4 million, payable \$163,000 in cash at closing, net of closing costs and property taxes of \$87,000, and a \$1.15 million 8% note receivable over a three-year period. The note is payable \$9,619 per month, principal and interest, for the first 35 months with the remaining balance payable at maturity. The buyer has the option to extend the maturity date by one year at least 60 days prior to maturity, as long as the buyer is not in default. The Company recorded a gain on the sale transaction of approximately \$383,000.

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On March 21, 2019, the Company sold a held-for-sale property adjacent to our Bombshells 249 location for a total sales price of \$1.4 million in cash. Net gain on the transaction amounted to approximately \$628,000 after closing costs. The Company used \$980,000 of the proceeds to pay off a loan related to the property.

In April 2019, the Company sold another held-for-sale property adjacent to our Bombshells I-10 location for a total sales price of \$1.1 million in cash. Net gain on the transaction amounted to approximately \$331,000 after closing costs. The Company used \$942,000 of the proceeds to pay off a loan related to the property.

In June 2019, the Company sold a property located in Lubbock, Texas for \$350,000 in cash. Net loss on the transaction amounted to \$376,000 after closing costs. The Company used \$331,000 of the proceeds from the sale to pay down debt.

In June 2019, the Company sold an aircraft for \$690,000 in cash. Net loss on the transaction amounted to \$9,000 after closing costs. The Company used \$666,000 of the proceeds from the sale to pay down related debt.

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion should be read in conjunction with our unaudited condensed consolidated financial statements and related notes thereto included in this quarterly report, and the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended September 30, 2018.

Overview

RCI Hospitality Holdings, Inc. (“RCIHH”) is a holding company engaged in a number of activities in the hospitality and related businesses. All services and management operations are conducted by subsidiaries of RCIHH, including RCI Management Services, Inc.

Through our subsidiaries, as of March 31, 2019, we operated a total of 47 establishments that offer live adult entertainment and/or restaurant and bar operations. We also operated a leading business communications company serving the multi-billion-dollar adult nightclubs industry. We have two principal reportable segments: Nightclubs and Bombshells. We combine other operating segments into “Other.” In the context of club and restaurant/sports bar operations, the terms the “Company,” “we,” “our,” “us” and similar terms used in this report refer to subsidiaries of RCIHH. RCIHH was incorporated in the State of Texas in 1994. Our corporate offices are located in Houston, Texas.

Critical Accounting Policies and Estimates

The preparation of the unaudited consolidated financial statements requires our management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On a regular basis, we evaluate these estimates, including investment impairment. These estimates are based on management’s historical industry experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results may differ from these estimates.

For a description of the accounting policies that, in management’s opinion, involve the most significant application of judgment or involve complex estimation and which could, if different judgment or estimates were made, materially affect our reported financial position, results of operations, or cash flows, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies and Estimates” in our Annual Report on Form 10-K for the fiscal year ended September 30, 2018 filed with the SEC on December 31, 2018.

During the three and six months ended March 31, 2019, there were no significant changes in our accounting policies and estimates other than the newly adopted accounting standards that are disclosed in Note 2 to our unaudited condensed consolidated financial statements.

Results of Operations

Highlights of the operating results and the strategic activities of the Company during the three and six months ended March 31, 2019 are as follows:

Second Quarter 2019

- Total revenues for the three months ended March 31, 2019 were \$44.8 million compared to \$41.2 million during the three months ended March 31, 2018, an 8.7% increase (Nightclubs revenue of \$37.0 million compared to \$35.4 million, a 4.5% increase; and Bombshells revenue of \$7.5 million compared to \$5.6 million, a 34.4% increase)
- Consolidated same-store sales decreased by 2.8% for the quarter (1.2% decrease for Nightclubs and 12.7% decrease for Bombshells)
- Basic and diluted earnings per share (“EPS”) of \$0.70 compared to \$0.48, a 45.8% increase (non-GAAP diluted EPS* of \$0.63 compared to \$0.65, a 3.1% decrease)
- Net cash provided by operating activities of \$9.5 million for the three months ended March 31, 2019 compared to \$5.9 million during the comparable prior-year period, a 60.5% increase (free cash flow* of \$8.8 million compared to \$5.3 million, a 66.3% increase)

Year-to-Date 2019

- Total revenues for the six months ended March 31, 2019 were \$88.8 million compared to \$82.4 million during the six months ended March 31, 2018, a 7.8% increase (Nightclubs revenue of \$74.8 million compared to \$70.7 million, a 5.8% increase; and Bombshells revenue of \$13.5 million compared to \$11.4 million, an 18.5% increase)
- Consolidated same-store sales decreased by 1.1% for the six months (1.5% increase for Nightclubs and 16.7% decrease for Bombshells)
- Basic and diluted EPS of \$1.35 compared to \$1.95, a 30.8% decrease (non-GAAP diluted EPS* of \$1.24 compared to \$1.18, a 5.1% increase)
- Net cash provided by operating activities of \$21.0 million for the six months ended March 31, 2019 compared to \$14.1 million during the comparable prior-year period, a 49.0% increase (free cash flow* of \$19.9 million compared to \$12.8 million, a 54.9% increase)
- Completed the acquisition of one club in Pittsburgh, Pennsylvania for \$15.0 million and another club in Chicago, Illinois for \$10.5 million

* Reconciliation and discussion of non-GAAP financial measures are included in the “Non-GAAP Financial Measures” section below.

Three Months Ended March 31, 2019 Compared to Three Months Ended March 31, 2018

The following table summarizes our results of operations for the three months ended March 31, 2019 and 2018 (dollars in thousands):

| | For the Three Months Ended | | | | Increase (Decrease) | |
|--|----------------------------|---------------|-----------------|---------------|---------------------|--------------|
| | March 31, 2019 | | March 31, 2018 | | Amount | % |
| | Amount | % of Revenues | Amount | % of Revenues | | |
| Revenues | | | | | | |
| Sales of alcoholic beverages | \$ 18,486 | 41.2% | \$ 17,372 | 42.1% | \$ 1,114 | 6.4% |
| Sales of food and merchandise | 6,439 | 14.4% | 5,424 | 13.2% | 1,015 | 18.7% |
| Service revenues | 16,979 | 37.9% | 16,133 | 39.1% | 846 | 5.2% |
| Other | 2,922 | 6.5% | 2,297 | 5.6% | 625 | 27.2% |
| Total revenues | <u>44,826</u> | <u>100.0%</u> | <u>41,226</u> | <u>100.0%</u> | <u>3,600</u> | <u>8.7%</u> |
| Operating expenses | | | | | | |
| Cost of goods sold | | | | | | |
| Alcoholic beverages sold | 3,790 | 20.5% | 3,589 | 20.7% | 201 | 5.6% |
| Food and merchandise sold | 2,308 | 35.8% | 1,964 | 36.2% | 344 | 17.5% |
| Service and other | 94 | 0.5% | 43 | 0.2% | 51 | 118.6% |
| Total cost of goods sold (exclusive of items shown separately below) | 6,192 | 13.8% | 5,596 | 13.6% | 596 | 10.7% |
| Salaries and wages | 11,908 | 26.6% | 10,347 | 25.1% | 1,561 | 15.1% |
| Selling, general and administrative | 14,341 | 32.0% | 12,848 | 31.2% | 1,493 | 11.6% |
| Depreciation and amortization | 2,200 | 4.9% | 1,899 | 4.6% | 301 | 15.9% |
| Other charges (gains), net | (981) | -2.2% | 2,305 | 5.6% | (3,286) | -142.6% |
| Total operating expenses | <u>33,660</u> | <u>75.1%</u> | <u>32,995</u> | <u>80.0%</u> | <u>665</u> | <u>2.0%</u> |
| Income from operations | 11,166 | 24.9% | 8,231 | 20.0% | 2,935 | 35.7% |
| Other income (expenses) | | | | | | |
| Interest expense | (2,645) | -5.9% | (2,106) | -5.1% | 539 | 25.6% |
| Interest income | 75 | 0.2% | 68 | 0.2% | 7 | 10.3% |
| Non-operating gain | 77 | 0.2% | - | - | 77 | 100.0% |
| Income before income taxes | 8,673 | 19.3% | 6,193 | 15.0% | 2,480 | 40.0% |
| Income tax expense | 1,930 | 4.3% | 1,499 | 3.6% | 431 | 28.8% |
| Net income | <u>\$ 6,743</u> | <u>15.0%</u> | <u>\$ 4,694</u> | <u>11.4%</u> | <u>\$ 2,049</u> | <u>43.7%</u> |

* Percentages may not foot due to rounding. Percentage of revenue for individual cost of goods sold items pertains to their respective revenue line.

Revenues

Consolidated revenues increased by \$3.6 million, or 8.7%, due primarily to a 12.5% increase from new units, a 2.8% decrease in same-store sales (contributing the same percentage decrease in total revenues), a 1.6% decrease from closed units, and a 0.6% increase in other revenues. Nightclub same-store sales decreased by 1.2% while Bombshells same-store sales decreased by 12.7%.

Segment contribution to total revenues was as follows (in thousands):

| | For the Three Months Ended March 31, | |
|------------|---|------------------|
| | 2019 | 2018 |
| Nightclubs | \$ 37,047 | \$ 35,443 |
| Bombshells | 7,527 | 5,602 |
| Other | 252 | 181 |
| | <u>\$ 44,826</u> | <u>\$ 41,226</u> |

Nightclubs same-store sales declined during the quarter due to high comparable sales in the prior-year quarter caused by the impact of the pro football championship in Minneapolis in February 2018. Excluding Minneapolis clubs, Nightclubs same-store sales increased by 1.0%, continuing to reflect effective marketing, management and appeal, combined with a good economy. Sales from new clubs included \$2.3 million from the two clubs we acquired in November 2018 and \$220,000 from a club acquired in May 2018.

New Bombshells units contributed approximately \$2.6 million, with the 12.7% same-store sales decline sequentially better than last quarter reflecting increases in all five units.

Operating Expenses

Total operating expenses, as a percent of revenues, decreased to 75.1% from 80.0% from year-ago although dollar value increased by \$665,000, or 2.0%, which was significantly affected by gains from the sale of two properties held for sale. Significant contributors to the changes in operating expenses are explained below.

Cost of goods sold increased by 10.7% mainly due to the increase in sales. As a percent of total revenues, cost of goods sold increased to 13.8% from 13.6% due to the higher increase in lower-margin Bombshells sales.

Salaries and wages increased by \$1.6 million, or 15.1%, mainly due to newly acquired and opened units, especially those new Bombshells opening/training teams whose restaurants have not yet contributed to the sales base. As a percent of total revenues, salaries and wages were 26.6% from 25.1% mainly due to pre-opening teams on new Bombshells units.

Selling, general and administrative expenses increased by \$1.5 million, or 11.6%, primarily due to increases in professional fees, taxes and permits, advertising and marketing, repairs and maintenance, and various other individually insignificant increases, partially offset by a decrease in legal fees. Professional fees increased mainly due to higher audit fee; taxes and permits increased due to new acquisitions; while advertising and marketing and repairs and maintenance increased primarily due to additional expenses from acquired clubs and a new marketing program for Bombshells. Legal expenses decreased in relation to settlements. As a percent of total revenues, selling, general and administrative expenses increased to 32.0% from 31.2% mainly due to professional fees.

Depreciation and amortization increased by \$301,000, or 15.9% due to higher unit count from new construction and acquisitions.

Other charges (gains), net resulted to a net gain of \$1.0 million in the current quarter compared to a net charge of \$2.3 million in the prior-year quarter. The swing was primarily due to the net gain of approximately \$1.0 million from the sale of two properties during the quarter compared to an impairment charge of \$1.6 million and settlement of lawsuits of \$772,000 in the comparable prior period.

Income from Operations

For the three months ended March 31, 2019 and 2018, our operating margin was 24.9% and 20.0%, respectively. The main drivers for the increase in operating margin are discussed above, but more significantly from other charges/gains and salaries and wages.

Segment contribution to income from operations is presented in the table below (in thousands):

| | For the Three Months Ended March 31, | |
|-------------------|---|-----------------|
| | 2019 | 2018 |
| Nightclubs | \$ 15,078 | \$ 11,880 |
| Bombshells | 738 | 965 |
| Other | (176) | (82) |
| General corporate | (4,474) | (4,532) |
| | <u>\$ 11,166</u> | <u>\$ 8,231</u> |

Operating margin for the Nightclubs segment was 40.7% and 33.5% for the three months ended March 31, 2019 and 2018, respectively, while operating margin for Bombshells was 9.8% and 17.2%, respectively. The increase in Nightclubs operating margin was mainly due to the net gain in the current quarter compared to the net charges in the prior year, and fixed expense leverage from higher sales. The decrease in Bombshells operating margin was primarily due to negative same-store sales. Excluding other gains/charges and settlement of lawsuits, Nightclubs would have had non-GAAP operating margin of 38.2% and 35.1% for the three months ended March 31, 2019 and 2018, respectively, while Bombshells would have had non-GAAP operating margin of 9.8% and 20.8%, respectively.

Non-Operating Items

Interest expense increased to \$2.6 million from \$2.1 million due to higher average debt balance and a slightly higher average interest rate.

Our total occupancy costs, defined as the sum of rent expense and interest expense, were 8.0% and 7.4% of revenue during the quarter ended March 31, 2019 and 2018, respectively. The higher occupancy costs in the current quarter were due to the interest expense incurred from debt used at several Bombshells real estate acquisitions (excluding construction costs), which do not contribute to revenue, and the debt incurred on the two November 2018 club acquisitions, as well as higher average debt balances.

Income Taxes

Income taxes were an expense of \$1.9 million in the second quarter of 2019 compared to \$1.5 million in the second quarter of 2018. The effective income tax rate for the second quarter of 2019 was an expense of 22.3% compared to 24.2% for the second quarter of 2018. Our effective tax rate is affected by state taxes, permanent differences, and tax credits, including the FICA tip credit.

The Tax Cuts and Jobs Act (“Tax Act”) was enacted on December 22, 2017, and includes, among other items, a reduction in the federal corporate income tax rate from 35% to 21% effective January 1, 2018. Our federal corporate income tax rate for fiscal 2018 was 24.5% percent and represents a blended income tax rate for our fiscal year ended September 30, 2018. For fiscal 2019, our federal corporate income tax rate is 21%.

Additionally, for the fiscal year ended September 30, 2018, in accordance with FASB ASC Topic 740, we remeasured our deferred tax balances to reflect the reduced rate that will apply when these deferred taxes are settled or realized in future periods. The remeasurement resulted in a \$8.7 million full year adjustment of our net deferred tax liabilities reflected in our consolidated balance sheet as of September 30, 2018 and a corresponding income tax benefit reflected in our consolidated statements of income for the fiscal year ended September 30, 2018. The SEC staff issued Staff Accounting Bulletin No. 118, which allows companies to record provisional amounts during a measurement period that is similar to the measurement period used when accounting for business combinations. There were no additional measurement adjustments since September 30, 2018 until the end of the measurement period on December 22, 2018.

Six Months Ended March 31, 2019 Compared to Six Months Ended March 31, 2018

The following table summarizes our results of operations for the six months ended March 31, 2019 and 2018 (dollars in thousands):

| | For the Six Months Ended | | | | Increase (Decrease) | |
|--|--------------------------|---------------|------------------|---------------|---------------------|---------------|
| | March 31, 2019 | | March 31, 2018 | | Amount | % |
| | Amount | % of Revenues | Amount | % of Revenues | | |
| Revenues | | | | | | |
| Sales of alcoholic beverages | \$ 36,796 | 41.4% | \$ 35,177 | 42.7% | \$ 1,619 | 4.6% |
| Sales of food and merchandise | 12,129 | 13.7% | 10,731 | 13.0% | 1,398 | 13.0% |
| Service revenues | 34,310 | 38.6% | 32,022 | 38.8% | 2,288 | 7.1% |
| Other | 5,614 | 6.3% | 4,508 | 5.5% | 1,106 | 24.5% |
| Total revenues | <u>88,849</u> | <u>100.0%</u> | <u>82,438</u> | <u>100.0%</u> | <u>6,411</u> | <u>7.8%</u> |
| Operating expenses | | | | | | |
| Cost of goods sold | | | | | | |
| Alcoholic beverages sold | 7,526 | 20.5% | 7,344 | 20.9% | 182 | 2.5% |
| Food and merchandise sold | 4,292 | 35.4% | 4,058 | 37.8% | 234 | 5.8% |
| Service and other | 186 | 0.5% | 79 | 0.2% | 107 | 135.4% |
| Total cost of goods sold (exclusive of items shown separately below) | 12,004 | 13.5% | 11,481 | 13.9% | 523 | 4.6% |
| Salaries and wages | 24,004 | 27.0% | 21,724 | 26.4% | 2,280 | 10.5% |
| Selling, general and administrative | 28,368 | 31.9% | 25,660 | 31.1% | 2,708 | 10.6% |
| Depreciation and amortization | 4,253 | 4.8% | 3,808 | 4.6% | 445 | 11.7% |
| Other charges (gains), net | (2,078) | -2.3% | 2,394 | 2.9% | (4,472) | -186.8% |
| Total operating expenses | <u>66,551</u> | <u>74.9%</u> | <u>65,067</u> | <u>78.9%</u> | <u>1,484</u> | <u>2.3%</u> |
| Income from operations | 22,298 | 25.1% | 17,371 | 21.1% | 4,927 | 28.4% |
| Other income (expenses) | | | | | | |
| Interest expense | (5,166) | -5.8% | (5,185) | -6.3% | (19) | -0.4% |
| Interest income | 126 | 0.1% | 135 | 0.2% | (9) | -6.7% |
| Non-operating loss | (370) | -0.4% | - | - | (370) | -100.0% |
| Income before income taxes | 16,888 | 19.0% | 12,321 | 14.9% | 4,567 | 37.1% |
| Income tax expense (benefit) | 3,741 | 4.2% | (6,728) | -8.2% | 10,469 | 155.6% |
| Net income | <u>\$ 13,147</u> | <u>15.0%</u> | <u>\$ 19,049</u> | <u>23.1%</u> | <u>\$ (5,902)</u> | <u>-31.0%</u> |

* Percentages may not foot due to rounding. Percentage of revenue for individual cost of goods sold items pertains to their respective revenue line.

Revenues

Consolidated revenues increased by \$6.4 million, or 7.8%, due primarily to a 10.2% increase from new units, a 1.9% decrease from closed units, a 1.1% decrease in same-store sales (contributing the same percentage decrease in total revenues), and a 0.5% increase in other revenues. Nightclub same-store sales increased by 1.5% while Bombshells same-store sales decreased by 16.7%.

Segment contribution to total revenues was as follows (in thousands):

| | For the Six Months Ended March 31, | |
|------------|---------------------------------------|------------------|
| | 2019 | 2018 |
| Nightclubs | \$ 74,775 | \$ 70,661 |
| Bombshells | 13,540 | 11,430 |
| Other | 534 | 347 |
| | <u>\$ 88,849</u> | <u>\$ 82,438</u> |

Nightclubs same-store sales growth continued to reflect effective marketing, management and appeal, combined with a good economy, partially offset by the impact of the pro football championship on our Minneapolis clubs.

Bombshells same-store sales decline of 16.7% improved from the first quarter due to gradually improving sales caused by prior year higher comparisons. New Bombshells still not in the same-store base contributed \$4.0 million in revenue for the period.

Operating Expenses

Total operating expenses, as a percent of revenues, decreased to 74.9% from 78.9% from a year-ago although dollar value increased by \$1.5 million, or 2.3%. Significant contributors to the changes in operating expenses are explained below.

Cost of goods sold increased by 4.6% mainly due to net additional units. As a percent of total revenues, cost of goods sold decreased to 13.5% from 13.9% due to tighter food cost control for the Nightclubs segment.

Salaries and wages increased by \$2.3 million, or 10.5%, mainly due to newly acquired and opened units, especially those new Bombshells opening/training teams whose restaurants have not yet contributed to the sales base. As a percent of total revenues, salaries and wages were 27.0% from 26.4% mainly due to pre-opening teams on new Bombshells units.

Selling, general and administrative expenses increased by \$2.7 million, or 10.6%, primarily due to increases in legal expenses, advertising and marketing, taxes and permits, professional fees, supplies, repairs and maintenance, and various other individually insignificant increases. Legal expenses increased primarily due to trial costs associated with two cases and the acquisition of two clubs in the first quarter of 2019. Professional fees increased mainly due higher audit fees; taxes and permits increased due to new acquisitions; while advertising and marketing increased primarily due to additional expenses from acquired clubs and a new marketing program for Bombshells. Supplies expense and repairs and maintenance increased due to increased unit count. As a percent of total revenues, selling, general and administrative expenses increased to 31.9% from 31.1% mainly due to legal and professional fees.

Depreciation and amortization increased by \$445,000, or 11.7% due to higher unit count from new construction and acquisitions.

Other charges (gains), net resulted to a net gain of \$2.1 million in the current six-month period compared to a net charge of \$2.4 million in the prior-year six-month period. The shift were caused by the net gain of approximately \$1.0 million from the sale of two properties during the second quarter compared to an impairment charge of \$1.6 million and settlement of lawsuits of \$772,000 in the prior-year second quarter, and the combined gains of approximately \$1.2 million from the sale of a club in Philadelphia and two assets held for sale in the first quarter of the current year.

Income from Operations

For the six months ended March 31, 2019 and 2018, our operating margin was 25.1% and 21.1%, respectively. The main drivers for the increase in operating margin are discussed above.

Segment contribution to income from operations is presented in the table below (in thousands):

| | For the Six Months Ended March 31, | |
|-------------------|---|------------------|
| | 2019 | 2018 |
| Nightclubs | \$ 30,465 | \$ 25,251 |
| Bombshells | 857 | 1,856 |
| Other | (295) | (219) |
| General corporate | (8,729) | (9,517) |
| | <u>\$ 22,298</u> | <u>\$ 17,371</u> |

Operating margin for the Nightclubs segment was 40.7% and 35.7% for the six months ended March 31, 2019 and 2018, respectively, while operating margin for Bombshells was 6.3% and 16.2%, respectively. The increase in Nightclubs operating margin was mainly due to the net gain in the current year compared to the net charges in the prior year. The decrease in Bombshells operating margin was primarily due to negative same-store sales.

Non-Operating Items

Interest expense remained flat at \$5.2 million for both the six months ended March 31, 2019 and 2018.

Our total occupancy costs, defined as the sum of rent expense and interest expense, exclusive of prior-year refinancing-related costs above, were 8.0% and 7.6% of revenue during the six months ended March 31, 2019 and 2018, respectively. The higher occupancy costs were due to the interest expense incurred from debt used at several Bombshells real estate acquisitions (excluding construction costs), which do not contribute to revenue, and the debt incurred on the two November 2018 club acquisitions, as well as higher average debt balance.

As part of our adoption of ASU 2016-01, we recorded a \$370,000 net unrealized loss on the market value of equity securities during the current year. The cumulative net gain in market value of available-for sale securities, which was recorded in accumulated other comprehensive income as of September 30, 2018, has been reclassified to retained earnings as of the beginning of fiscal year 2019.

Income Taxes

Income taxes were an expense of \$3.7 million during the six months ended March 31, 2019 compared to a benefit of \$6.7 million during the same period of 2018. The effective income tax rate for the six-month period of 2019 was an expense of 22.2% compared to a benefit of 54.6% for the same period in 2018. Our effective tax rate is affected by state taxes, permanent differences, and tax credits, including the FICA tip credit, for both years while the first quarter of 2018 was significantly impacted by a \$9.7 million reduction of our deferred tax liability caused by newly enacted tax laws.

The Tax Cuts and Jobs Act (“Tax Act”) was enacted on December 22, 2017, and includes, among other items, a reduction in the federal corporate income tax rate from 35% to 21% effective January 1, 2018. Our federal corporate income tax rate for fiscal 2018 was 24.5% percent and represents a blended income tax rate for our fiscal year ended September 30, 2018. For fiscal 2019, our federal corporate income tax rate is 21%.

Additionally, for the fiscal year ended September 30, 2018, in accordance with FASB ASC Topic 740, we remeasured our deferred tax balances to reflect the reduced rate that will apply when these deferred taxes are settled or realized in future periods. The remeasurement resulted in a \$8.7 million full year adjustment of our net deferred tax liabilities reflected in our consolidated balance sheet as of September 30, 2018 and a corresponding income tax benefit reflected in our consolidated statements of income for the fiscal year ended September 30, 2018. The SEC staff issued Staff Accounting Bulletin No. 118, which allows companies to record provisional amounts during a measurement period that is similar to the measurement period used when accounting for business combinations. There were no additional measurement adjustments since September 30, 2018 until the end of the measurement period on December 22, 2018.

Non-GAAP Financial Measures

In addition to our financial information presented in accordance with GAAP, management uses certain non-GAAP financial measures, within the meaning of the SEC Regulation G, to clarify and enhance understanding of past performance and prospects for the future. Generally, a non-GAAP financial measure is a numerical measure of a company's operating performance, financial position or cash flows that excludes or includes amounts that are included in or excluded from the most directly comparable measure calculated and presented in accordance with GAAP. We monitor non-GAAP financial measures because it describes the operating performance of the Company and helps management and investors gauge our ability to generate cash flow, excluding (or including) some items that management believes are not representative of the ongoing business operations of the Company, but are included in (or excluded from) the most directly comparable measures calculated and presented in accordance with GAAP. Relative to each of the non-GAAP financial measures, we further set forth our rationale as follows:

Non-GAAP Operating Income and Non-GAAP Operating Margin. We calculate non-GAAP operating income and non-GAAP operating margin by excluding the following items from income from operations and operating margin: (a) amortization of intangibles, (b) impairment of assets, (c) gains or losses on sale of businesses and assets, (d) gains or losses on insurance, and (e) settlement of lawsuits. We believe that excluding these items assists investors in evaluating period-over-period changes in our operating income and operating margin without the impact of items that are not a result of our day-to-day business and operations.

Non-GAAP Net Income and Non-GAAP Net Income per Diluted Share. We calculate non-GAAP net income and non-GAAP net income per diluted share by excluding or including certain items to net income attributable to RCIHH common stockholders and diluted earnings per share. Adjustment items are: (a) amortization of intangibles, (b) impairment of assets, (c) costs and charges related to debt refinancing, (d) gains or losses on sale of businesses and assets, (e) gains or losses on insurance, (f) unrealized gains or losses on equity securities, (g) settlement of lawsuits, and (h) the income tax effect of the above described adjustments. Included in the income tax effect of the above adjustments is the net effect of the non-GAAP provision for income taxes, calculated at 22.1% and 26.5% effective tax rate of the pre-tax non-GAAP income before taxes for the six months ended March 31, 2019 and 2018, respectively, and the GAAP income tax expense (benefit). We believe that excluding and including such items help management and investors better understand our operating activities.

Adjusted EBITDA. We calculate adjusted EBITDA by excluding the following items from net income attributable to RCIHH common stockholders: (a) depreciation expense, (b) amortization of intangibles, (c) income tax expense (benefit), (d) net interest expense, (e) gains or losses on sale of businesses and assets, (f) gains or losses on insurance, (g) unrealized gains or losses on equity securities, and (h) settlement of lawsuits. We believe that adjusting for such items helps management and investors better understand our operating activities. Adjusted EBITDA provides a core operational performance measurement that compares results without the need to adjust for federal, state and local taxes which have considerable variation between domestic jurisdictions. The results are, therefore, without consideration of financing alternatives of capital employed. We use adjusted EBITDA as one guideline to assess our unleveraged performance return on our investments. Adjusted EBITDA is also the target benchmark for our acquisitions of nightclubs.

We also use certain non-GAAP cash flow measures such as free cash flow. See "Liquidity and Capital Resources" section for further discussion.

The following tables present our non-GAAP performance measures for the three and six months ended March 31, 2019 and 2018 (in thousands, except per share amounts and percentages):

| | For the Three Months Ended March 31, | | For the Six Months Ended March 31, | |
|---|---|------------------|---------------------------------------|------------------|
| | 2019 | 2018 | 2019 | 2018 |
| Reconciliation of GAAP net income to Adjusted EBITDA | | | | |
| Net income attributable to RCIHH common stockholders | \$ 6,735 | \$ 4,685 | \$ 13,079 | \$ 18,996 |
| Income tax expense (benefit) | 1,930 | 1,499 | 3,741 | (6,728) |
| Interest expense, net | 2,570 | 2,038 | 5,040 | 5,050 |
| Settlement of lawsuits | 84 | 773 | 144 | 800 |
| Impairment of assets | - | 1,550 | - | 1,550 |
| Loss (gain) on sale of businesses and assets | (1,065) | (18) | (2,222) | 64 |
| Unrealized loss (gain) on equity securities | (77) | - | 370 | - |
| Gain on insurance | - | - | - | (20) |
| Depreciation and amortization | 2,200 | 1,899 | 4,253 | 3,808 |
| Adjusted EBITDA | <u>\$ 12,377</u> | <u>\$ 12,426</u> | <u>\$ 24,405</u> | <u>\$ 23,520</u> |

| | | | | |
|---|-----------------|-----------------|------------------|------------------|
| Reconciliation of GAAP net income to non-GAAP net income | | | | |
| Net income attributable to RCIHH common stockholders | \$ 6,735 | \$ 4,685 | \$ 13,079 | \$ 18,996 |
| Amortization of intangibles | 153 | 48 | 309 | 96 |
| Settlement of lawsuits | 84 | 773 | 144 | 800 |
| Impairment of assets | - | 1,550 | - | 1,550 |
| Loss (gain) on sale of businesses and assets | (1,065) | (18) | (2,222) | 64 |
| Unrealized loss (gain) on equity securities | (77) | - | 370 | - |
| Gain on insurance | - | - | - | (20) |
| Costs and charges related to debt refinancing | - | - | - | 827 |
| Income tax effect of adjustments above | 223 | (763) | 333 | (10,858) |
| Non-GAAP net income | <u>\$ 6,053</u> | <u>\$ 6,275</u> | <u>\$ 12,013</u> | <u>\$ 11,455</u> |

| | | | | |
|---|----------------|----------------|----------------|----------------|
| Reconciliation of GAAP diluted earnings per share to non-GAAP diluted earnings per share | | | | |
| Diluted shares | 9,679 | 9,719 | 9,696 | 9,719 |
| GAAP diluted earnings per share | \$ 0.70 | \$ 0.48 | \$ 1.35 | \$ 1.95 |
| Amortization of intangibles | 0.02 | 0.00 | 0.03 | 0.01 |
| Settlement of lawsuits | 0.01 | 0.08 | 0.01 | 0.08 |
| Impairment of assets | - | 0.16 | - | 0.16 |
| Loss (gain) on sale of businesses and assets | (0.11) | (0.00) | (0.23) | 0.01 |
| Unrealized loss (gain) on equity securities | (0.01) | - | 0.04 | - |
| Gain on insurance | - | - | - | (0.00) |
| Costs and charges related to debt refinancing | - | - | - | 0.09 |
| Income tax effect of adjustments above | 0.02 | (0.08) | 0.03 | (1.12) |
| Non-GAAP diluted earnings per share | <u>\$ 0.63</u> | <u>\$ 0.65</u> | <u>\$ 1.24</u> | <u>\$ 1.18</u> |

| | | | | |
|---|------------------|------------------|------------------|------------------|
| Reconciliation of GAAP operating income to non-GAAP operating income | | | | |
| Income from operations | \$ 11,166 | \$ 8,231 | \$ 22,298 | \$ 17,371 |
| Amortization of intangibles | 153 | 48 | 309 | 96 |
| Settlement of lawsuits | 84 | 773 | 144 | 800 |
| Impairment of assets | - | 1,550 | - | 1,550 |
| Gain on insurance | - | - | - | (20) |
| Loss (gain) on sale of businesses and assets | (1,065) | (18) | (2,222) | 64 |
| Non-GAAP operating income | <u>\$ 10,338</u> | <u>\$ 10,584</u> | <u>\$ 20,529</u> | <u>\$ 19,861</u> |

| | | | | |
|---|--------------|--------------|--------------|--------------|
| Reconciliation of GAAP operating margin to non-GAAP operating margin | | | | |
| GAAP operating margin | 24.9% | 20.0% | 25.1% | 21.1% |
| Amortization of intangibles | 0.3% | 0.1% | 0.3% | 0.1% |
| Settlement of lawsuits | 0.2% | 1.9% | 0.2% | 1.0% |
| Impairment of assets | - | 3.8% | - | 1.9% |
| Gain on insurance | - | - | - | 0.0% |
| Loss (gain) on sale of businesses and assets | -2.4% | -0.0% | -2.5% | 0.1% |
| Non-GAAP operating margin | <u>23.1%</u> | <u>25.7%</u> | <u>23.1%</u> | <u>24.1%</u> |

* Per share amounts and percentages may not foot due to rounding.

The adjustments to reconcile net income attributable to RCIIH common stockholders to non-GAAP net income exclude the impact of adjustments related to noncontrolling interests, which is immaterial.

Liquidity and Capital Resources

At March 31, 2019, our cash and cash equivalents were \$8.3 million compared to \$17.7 million at September 30, 2018. Because of the large volume of cash we handle, we have very stringent cash controls. As of March 31, 2019, we had negative working capital of \$2.8 million compared to a positive working capital of \$55,000 as of September 30, 2018, both figures excluding assets held for sale of \$668,000 as of March 31, 2019 and \$2.9 million as of September 30, 2018. We believe our ability to generate cash from operating activities is one of our fundamental financial strengths. Our net cash provided by operating activities increased to \$21.0 million for the six months ended March 31, 2019 from \$14.1 million for the six months ended March 31, 2018. The near-term outlook for our business remains strong, and we expect to generate substantial cash flows from operations for the next 12 months from the issuance of this report. As a result of our expected cash flows from operations, we have significant flexibility to meet our financial commitments.

We have not recently raised capital through the issuance of equity securities. Instead, we use debt financing to lower our overall cost of capital and increase our return on stockholders' equity. We have a history of borrowing funds in private transactions and from sellers in acquisition transactions, and have recently secured traditional bank financing on our new development projects and refinancing of our existing notes payable. We continue to have the ability to borrow funds at reasonable interest rates from those sources. We also have historically utilized these cash flows to invest in property and equipment, adult nightclubs and restaurants/sports bars.

The following table presents a summary of our cash flows from operating, investing, and financing activities (in thousands):

| | For the Six Months Ended March 31, | |
|--|---------------------------------------|-----------|
| | 2019 | 2018 |
| Operating activities | \$ 20,971 | \$ 14,077 |
| Investing activities | (24,888) | (8,291) |
| Financing activities | (5,554) | (3,208) |
| Net increase (decrease) in cash and cash equivalents | \$ (9,471) | \$ 2,578 |

Cash Flows from Operating Activities

Following are our summarized cash flows from operating activities (in thousands):

| | For the Six Months Ended March 31, | |
|--|---------------------------------------|-----------|
| | 2019 | 2018 |
| Net income | \$ 13,147 | \$ 19,049 |
| Depreciation and amortization | 4,253 | 3,808 |
| Deferred tax expense (benefit) | 1,131 | (9,659) |
| Debt prepayment penalty | - | 543 |
| Net change in operating assets and liabilities | 3,876 | (1,867) |
| Impairment of assets | - | 1,550 |
| Other | (1,436) | 653 |
| Net cash provided by operating activities | \$ 20,971 | \$ 14,077 |

Net cash provided by operating activities increased from year-to-year due primarily to the increase in income from operations, lower income taxes paid, and a favorable net change in operating assets and liabilities, partially offset by higher interest expense paid.

Cash Flows from Investing Activities

Following are our cash flows from investing activities (in thousands):

| | For the Six Months Ended March 31, | |
|---|---------------------------------------|------------|
| | 2019 | 2018 |
| Additions to property and equipment | \$ (13,902) | \$ (9,011) |
| Acquisition of businesses, net of cash acquired | (13,500) | - |
| Proceeds from sale of businesses and assets | 2,866 | 632 |
| Proceeds from insurance | - | 20 |
| Issuance of note receivable | (420) | - |
| Proceeds from notes receivable | 68 | 68 |
| Net cash used in investing activities | \$ (24,888) | \$ (8,291) |

Following is a breakdown of our additions to property and equipment for the six months ended March 31, 2019 and 2018 (in thousands):

| | For the Six Months Ended March 31, | |
|----------------------------------|---------------------------------------|----------|
| | 2019 | 2018 |
| New facilities and equipment | \$ 12,785 | \$ 7,749 |
| Maintenance capital expenditures | 1,117 | 1,262 |
| Total capital expenditures | \$ 13,902 | \$ 9,011 |

The capital expenditures during the six months ended March 31, 2019 were composed primarily of construction and development costs for four new locations, while the capital expenditures during the six months ended March 31, 2018 were composed primarily of construction and development costs for one new location. Variances in capital expenditures are primarily due to the number and timing of new, remodeled, or reconcepted locations under construction.

Acquisitions of \$13.5 million, excluding acquisition-related costs, for the six months ended March 31, 2019 relate to \$7.5 million cash paid on the Pittsburgh club acquisition and the \$6.0 million cash paid on the Chicago club acquisition.

Cash Flows from Financing Activities

Following are our cash flows from financing activities (in thousands):

| | For the Six Months Ended March 31, | |
|--|---------------------------------------|------------|
| | 2019 | 2018 |
| Proceeds from long-term debt | \$ 10,296 | \$ 62,453 |
| Payments on long-term debt | (13,287) | (63,518) |
| Debt prepayment penalty | - | (543) |
| Purchase of treasury stock | (1,961) | - |
| Payment of dividends | (582) | (583) |
| Payment of loan origination costs | (20) | (909) |
| Distribution to noncontrolling interests | - | (108) |
| Net cash used in financing activities | \$ (5,554) | \$ (3,208) |

We purchased 84,811 shares of our common stock at an average price of \$23.13 during the six months ended March 31, 2019, while we did not purchase shares of our Company's common stock during the same period last year. We paid quarterly dividends of \$0.03 per share during each of the current- and prior-year quarters.

On November 1, 2018, the Company raised \$2.35 million through the issuance of 12% unsecured promissory notes to certain investors, which notes mature on November 1, 2021. The notes pay interest-only in equal monthly installments, with a lump sum principal payment at maturity. Among the promissory notes are two notes with a principal of \$450,000 and \$200,000. The \$450,000 note was in exchange for a \$300,000 12% note and the \$200,000 note was in exchange for a \$100,000 note, both of which were included in the May 1, 2017 financing to acquire Scarlett's Cabaret in Miami. Also included in the \$2.35 million borrowing is a \$500,000 note borrowed from a related party and two notes totaling \$400,000 borrowed from a non-officer employee and a family member of a non-officer employee in which the terms of the notes are the same as the rest of the lender group. See Notes 6 and 13 to our unaudited condensed consolidated financial statements.

On December 6, 2018, the Company amended the \$5.0 million short-term note payable related to the Scarlett's acquisition, which had a remaining balance of \$3.0 million as of December 6, 2018, extending the maturity date from May 8, 2019, as previously amended, to May 8, 2020. See Note 6 to our consolidated financial statements.

On December 11, 2018, the Company purchased an aircraft for \$2.8 million with a \$554,000 down payment and financed the remaining \$2.2 million with a 5.49% promissory note payable in 20 years with monthly payments of \$15,118, including interest.

On February 8, 2019, the Company refinanced a one-year bank note with a balance of \$1.5 million, bearing an interest rate of 6.1%, with a construction loan with another bank, which has an interest rate of 6.0% adjusted after five years to prime plus 0.5% with a 6.0% floor per annum. The new construction loan, which has a maximum availability of \$4.1 million, matures in 252 months from closing date and is payable interest-only for the first 12 months, then principal and interest of \$29,571 monthly for the next 48 months, and the remaining term monthly payments of principal and interest based on the adjusted interest rate. The Company paid approximately \$69,000 in loan costs of which approximately \$19,600 was capitalized as debt issuance costs on the new construction loan with the remaining charged to interest expense. The Company also wrote off the remaining unamortized debt issuance costs of the old bank note to interest expense.

Included in the balance of long-term debt as of March 31, 2019 and September 30, 2018 is a \$200,000 note, that is a part of the May 1, 2017 financing, borrowed from a non-officer employee in which the terms of the note are the same as the rest of the lender group.

Management also uses certain non-GAAP cash flow measures such as free cash flow. Free cash flow is derived from net cash provided by operating activities less maintenance capital expenditures. We use free cash flow as the baseline for the implementation of our capital allocation strategy.

| | For the Six Months Ended March 31, | |
|---|---------------------------------------|-----------|
| | 2019 | 2018 |
| Net cash provided by operating activities | \$ 20,971 | \$ 14,077 |
| Less: Maintenance capital expenditures | 1,117 | 1,262 |
| Free cash flow | \$ 19,854 | \$ 12,815 |

Though we generated a sizeable amount of free cash flow during the quarter ended March 31, 2019, we still ended with a net decrease in cash and cash equivalents from the most recent year-end due to our acquisition of two new clubs and the construction of new Bombshells units.

Other than the notes payable financing described above, we are not aware of any event or trend that would potentially significantly affect liquidity. In the event such a trend develops, we believe our working capital and capital expenditure requirements will be adequately met by cash flows from operations. In our opinion, working capital is not a true indicator of our financial status. Typically, businesses in our industry carry current liabilities in excess of current assets because businesses in our industry receive substantially immediate payment for sales, with nominal receivables, while inventories and other current liabilities normally carry longer payment terms. Vendors and purveyors often remain flexible with payment terms, providing businesses in our industry with opportunities to adjust to short-term business down turns. We consider the primary indicators of financial status to be the long-term trend of revenue growth, the mix of sales revenues, overall cash flow, profitability from operations and the level of long-term debt.

The following table presents a summary of such indicators for the six months ended March 31:

| | <u>2019</u> | <u>Increase (Decrease)</u> | <u>2018</u> | <u>Increase (Decrease)</u> | <u>2017</u> |
|---|---------------|--------------------------------|---------------|--------------------------------|---------------|
| Sales of alcoholic beverages | \$ 36,796 | 4.6% | \$ 35,177 | 23.0% | \$ 28,610 |
| Sales of food and merchandise | 12,129 | 13.0% | 10,731 | 25.4% | 8,560 |
| Service revenues | 34,310 | 7.1% | 32,022 | 15.8% | 27,645 |
| Other | 5,614 | 24.5% | 4,508 | 31.0% | 3,442 |
| Total revenues | 88,849 | 7.8% | 82,438 | 20.8% | 68,257 |
| Net cash provided by operating activities | \$ 20,971 | 49.0% | \$ 14,077 | 27.6% | \$ 11,030 |
| Adjusted EBITDA* | \$ 24,405 | 3.8% | \$ 23,520 | 36.5% | \$ 17,233 |
| Free cash flow* | \$ 19,854 | 54.9% | \$ 12,815 | 28.4% | \$ 9,979 |
| Long-term debt (end of period) | \$ 149,818 | 17.8% | \$ 127,213 | 24.4% | \$ 102,300 |

* See definition and calculation of Adjusted EBITDA and Free Cash Flow above in the Non-GAAP Financial Measures subsection of Results of Operations.

Share Repurchase

We purchased 84,811 shares of our common stock at an average price of \$23.13 per share during the six months ended March 31, 2019, while we did not purchase shares of our common stock during the same period last year. In January 2019, the Company's Board of Directors authorized an additional \$10.0 million to repurchase the Company's common stock. As of March 31, 2019, we have \$11.2 million remaining to purchase additional shares under our share repurchase program.

Other Liquidity and Capital Resources

We have not established financing other than the notes payable discussed in Note 6 to the consolidated financial statements. There can be no assurance that we will be able to obtain additional financing on reasonable terms in the future, if at all, should the need arise.

We believe that the adult entertainment industry standard of treating entertainers as independent contractors provides us with safe harbor protection to preclude payroll tax assessment for prior years. We have prepared plans that we believe will protect our profitability in the event that the sexually-oriented business industry is required in all states to convert dancers who are now independent contractors into employees.

The sexually-oriented business industry is highly competitive with respect to price, service and location, as well as the professionalism of the entertainment. Although management believes that we are well-positioned to compete successfully in the future, there can be no assurance that we will be able to maintain our high level of name recognition and prestige within the marketplace.

Impact of Inflation

We have not experienced a material overall impact from inflation in our operations during the past several years. To the extent permitted by competition, we have managed to recover increased costs through price increases and may continue to do so. However, there can be no assurance that we will be able to do so in the future.

Seasonality

Our nightclub operations are affected by seasonal factors. Historically, we have experienced reduced revenues from April through September (our fiscal third and fourth quarters) with the strongest operating results occurring during October through March (our fiscal first and second quarters). Our revenues in certain markets are also affected by sporting events that cause unusual changes in sales from year to year.

Capital Allocation Strategy

Our capital allocation strategy provides us with disciplined guidelines on how we should use our free cash flows; provided however, that we may deviate from this strategy if the circumstances warrant. We calculate free cash flow as net cash flows from operating activities minus maintenance capital expenditures. Using the after-tax yield of buying our own stock as baseline, we believe we are able to make better investment decisions unless there is another strategic rationale, in management's opinion.

Based on our current capital allocation strategy:

- We consider buying back our own stock if the after-tax yield on free cash flow climbs over 10%;
- We consider disposing of underperforming units to free up capital for more productive use;
- We consider acquiring or developing our own clubs or restaurants that we believe have the potential to provide a minimum cash on cash return of 25%-33%, absent an otherwise strategic rationale;
- We consider paying down our most expensive debt if it makes sense on a tax adjusted basis, or there is an otherwise strategic rationale.

Growth Strategy

We believe that our nightclub operations can continue to grow organically and through careful entry into markets and demographic segments with high growth potential. Our growth strategy involves the following: (i) to acquire existing units in locations that are consistent with our growth and income targets and which appear receptive to the upscale club formula we have developed; (ii) to open new units after market analysis; (iii) to franchise our Bombshells brand; (iv) to form joint ventures or partnerships to reduce start-up and operating costs, with us contributing equity in the form of our brand name and management expertise; (v) to develop new club concepts that are consistent with our management and marketing skills; (vi) to develop and open our restaurant concepts as our capital and manpower allow; and (vii) to control the real estate in connection with club operations, although some units may be in leased premises.

We believe that Bombshells can grow organically and through careful entry into markets and demographic segments with high growth potential. All seven of the currently existing Bombshells are located in Texas. Our growth strategy is to diversify our operations with these units which do not require SOB licenses, which are sometimes difficult to obtain. While we are searching for adult nightclubs to acquire, we are able to also search for restaurant/sports bar locations that are consistent with our income targets.

We opened two Bombshells in fiscal 2019, one that opened in December 2018 and another that opened in March 2019. We currently have two Bombshells projects under construction, which are expected to open in early first quarter of fiscal 2020.

We continue to evaluate opportunities to acquire new nightclubs and anticipate acquiring new locations that fit our business model as we have done in the past. The acquisition of additional clubs may require us to take on additional debt or issue our common stock, or both. There can be no assurance that we will be able to obtain additional financing on reasonable terms in the future, if at all, should the need arise. An inability to obtain such additional financing could have an adverse effect on our growth strategy.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

As of March 31, 2019, there were no material changes to the information provided in Item 7A of the Company's Annual Report on Form 10-K for fiscal year ended September 30, 2018.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures, defined in Rule 13a-15(e) under the Exchange Act, that are designed to ensure that the information required to be filed or submitted with the SEC under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management of the company with the participation of its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

In connection with the preparation of this Quarterly Report on Form 10-Q for the quarter ended March 31, 2019, an evaluation was performed under the supervision and with the participation of management, including the chief executive officer and chief financial officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on their evaluation, they have concluded that our disclosure controls and procedures were not effective as of March 31, 2019. This determination is based on the previously reported material weaknesses management previously identified in our internal control over financial reporting, as described below, and on the conclusion to supplement certain disclosure in our Annual Report on Form 10-K for the fiscal year ended September 30, 2018, as described in our Form 8-K filed on July 22, 2019. We are in the process of remediating the material weaknesses in our internal control, as described below, and we are implementing a more robust corporate and accounting governance program, as described in the July 22, 2019 Form 8-K. We believe the completion of these processes should remedy our disclosure controls and procedures. We will continue to monitor these issues.

Previously Reported Material Weaknesses in Internal Control Over Financial Reporting

In our Annual Report for the year ended September 30, 2018, filed with the SEC on December 31, 2018, management concluded that our internal control over financial reporting was not effective as of September 30, 2018. In management's evaluation, the following deficiencies were identified as material weaknesses:

- **Control Environment**

The control environment, which is the responsibility of senior management, helps set the tone of the organization, influences the control consciousness of its officers and employees, and is an important component affecting how the organization performs financial analysis, accounting and financial reporting. A proper organizational tone can be promoted through a variety of means, such as well documented and communicated policies, a commitment to hiring competent employees, the manner and content of oral and written communications, strong internal controls and effective governance.

- Control Environment, Risk Assessment and Monitoring

We did not properly design or maintain effective controls over the control environment, risk assessment, and monitoring components which contributed to a number of material weaknesses at the control activity level. As it relates to the control environment and risk assessment, we did not have a sufficient complement of accounting, financial, and information technology personnel with an appropriate level of knowledge to assess internal control risks, address known internal control weaknesses, and address the Company's overall financial reporting and information technology requirements. As it relates to monitoring, we did not perform timely and ongoing evaluations to ascertain whether the components of internal control are present and functioning. The failures within these three COSO components contributed to the following material weaknesses at the control activity level:

- Control Activities

- Revenues – We did not properly design or maintain effective controls over the segregation of cash counts at our nightclubs and restaurants, the information produced by our point-of-sale systems, other revenues generated outside the point-of-sale system, and the review of journal entries used to record revenue transactions.
- Complex Accounting and Management Estimates – We did not properly design or maintain effective controls over complex accounting and management estimates related to the impairment analyses for indefinite lived intangible assets, goodwill, and property and equipment, and the accounting for income taxes, assets held for sale, business combinations, debt modifications, and useful lives of leasehold improvements, which resulted in certain instances of incorrect accounting and improper valuation decisions.
- Financial Statement Close and Reporting – We did not properly design or maintain effective controls, in aggregate, over the period end financial close and reporting process to enable timely reporting of complete and accurate financial information. Specifically, we lacked controls to define financial statement review thresholds, consistently perform independent reviews of journal entries prior to posting, and consistently prepare, approve, and retain adequate supporting documentation for financial statement balances and the related footnote disclosures.
- Information Technology – We did not properly design or maintain effective controls to prevent unauthorized access to certain systems, programs and data, and provide for periodic review and monitoring of access and changes in programs, including review of security logs and analysis of segregation of duties conflicts.
- Segregation of Duties – We did not maintain effective policies, procedures, or controls in aggregate to ensure adequate segregation of duties within the Company's business processes, financial applications, and IT systems. Specifically, we did not have appropriate controls in place to adequately assess the segregation of job responsibilities and system user access for initiating, authorizing, and recording transactions.

Remediation Efforts to Address Material Weaknesses

As disclosed in our most recent Annual Report on Form 10-K, we have, and continue to, identify and implement actions to improve our internal control over financial reporting and disclosure controls and procedures including actions to enhance our resources and training with respect to financial reporting and disclosure responsibilities, and increase utilization of accounting system functionality, with continued oversight from the Audit Committee.

We have taken, and continue to take, the actions described below to remediate the identified material weaknesses. As we continue to evaluate and work to improve our internal controls over financial reporting, our senior management may determine to take additional measures to address control deficiencies or determine to modify the remediation efforts described in this section. While the Audit Committee and senior management are closely monitoring the implementation, until the remediation efforts discussed in this section, including any additional remediation efforts that our senior management identifies as necessary, are completed, tested and determined effective, the material weaknesses described above will continue to exist.

Control Environment, Risk Assessment and Monitoring

Our Board of Directors has directed senior management to ensure that a proper, consistent tone is communicated throughout the organization, which emphasizes the expectation that previously existing deficiencies will be rectified through implementation of processes and controls to ensure strict compliance with U.S. GAAP and regulatory requirements. We also have taken steps to effect a proper tone through our policies and personnel. To effect this, we have retained an external consulting firm to effectively act as an internal audit department to assist in implementing an enterprise risk assessment which would include following up with additional internal audits as needed. The external consulting firm will also provide additional scrutiny around control activities and help with the enhancement of ongoing monitoring activities related to such controls.

Control Activities

Strengthening the controls and processes regarding the recording and reporting of revenue – Currently, one of our point-of-sale (“POS”) system providers does not issue an SOC 1 report. An SOC 1 Report (System and Organization Controls Report) is a report on Controls at a Service Organization which are relevant to user entities’ internal control over financial reporting. As a result of the non-issuance of this report by the provider, it is necessary for us to use alternative procedures to gain the required level of confidence regarding the reliability of this system to accurately report sale information. In the case of credit card sales, data is effectively processed using other third-party providers with whom we have a higher degree of confidence. We will work to implement stronger controls regarding the verification of data from the POS provider if no service provider internal controls adequacy report can be obtained. In the case of cash sales, we would seek to point to compensating detective controls, such as nightly cash counts, recurring surprise unannounced cash audits and monthly detailed revenue reconciliations to potentially detect any irregularities. Such controls will be evaluated for proper segregation of duties both in the nightly cash counts and in the related journal entries to remediate controls over both point-of-sale and other revenues. We have strengthened these controls and are continuously working with our system provider to ensure the required level of confidence necessary to prevent any material weaknesses in the future.

Strengthening internal controls over complex accounting and management estimates and financial statement preparation – Subsequent to September 30, 2018, we have added review procedures and controls over complex accounting and estimates and prevent instances of incorrect accounting, incorrect financial statement preparation and improper valuation decisions, by increasing our own level of competency as well as using third-party consultants to assist where necessary such as with our goodwill, indefinite-lived intangible assets, and property and equipment impairment analyses whenever necessary and also using appropriate third-party resources to help with the analysis and accounting for assets held for sale, business combinations, income taxes, debt modifications, assessment of useful lives of leasehold improvements, and other complex accounting matters.

Strengthening internal controls over financial statement close and reporting – With the oversight of our Audit Committee, we have continued to take proactive steps and implement additional measures to remediate the underlying causes of the material weaknesses. We are taking significant steps to improve our risk assessment process and monitoring structure, as follows:

- The new ERP system described below has and will continue to assist us in strengthening the controls over financial reporting, and we have also added an overlay of review of our financial statements during our financial reporting process. In addition, we have further trained our current personnel and have expanded our accounting team to assist in the review of our financial reporting.
- On top of the ERP system described above, we have also implemented, in April 2018, a new monitoring and security software to automate identification of our segregation of duties conflicts, as well as improve access monitoring controls and generate compliance documentation. The effective implementation of this software remains in process as we continually evaluate both manual and automated controls impacted by segregation of duties.
- We have retained a more robust outside consulting firm to assist us in evaluating, redesigning and implementing necessary steps to maintain adequate internal controls. Given that this is the second year of performing internal audit services, there have been many synergies, operational efficiencies and alignment between management and our consulting firm.
- We have developed more robust controls to evaluate monthly and quarterly financial statement variances.
- We have developed more robust controls over the review and evaluation of financial statement balances and the related footnote disclosures.
- We have started to implement certain enhanced journal review procedures which will ensure that proper review can be executed and evidenced.

Strengthening the information technology application – We were previously aware of the limitations of our accounting software and had been in the planning/implementation process of replacing the software for many months prior to September 30, 2017. In October 2017, we completed the conversion to a new Enterprise Resource Planning (“ERP”) system which, along with changes to our manual internal controls, we believe has resolved some of the issues detailed above relating to the information systems. The new ERP system has features that prevent unauthorized access to certain programs and data, and also provides for periodic review and monitoring of access including review of security logs. In addition to the ERP system, we are taking steps to improve monitoring of access to point-of-sale systems at remote locations, as well as review of change management protocols.

Strengthening our segregation of duties issues – The features mentioned above include proper segregation of duties within our journal entry process, including analysis of segregation of duties conflicts, which we hope to more fully utilize in fiscal year 2019. We have also hired a Director of ERP & Business Intelligence. In addition to the segregation of duties improvements, there will be continuing improvements in the controls that would mitigate any potential conflicts, most importantly regarding the length of time the controls have been operating effectively.

Changes in Internal Control Over Financial Reporting

Other than as described above, no changes in the Company’s internal control over financial reporting that occurred during the quarter ended March 31, 2019 that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

PART II—OTHER INFORMATION

Item 1. Legal Proceedings.

See the “Legal Matters” section within Note 10 of the unaudited condensed consolidated financial statements within this Quarterly Report on Form 10-Q, which information is incorporated herein by reference.

Item 1A. Risk Factors.

There were no material changes to the risk factors disclosed in the Company’s Annual Report on Form 10-K for the fiscal year ended September 30, 2018, except for such risks and uncertainties that may result from the additional disclosure in the “Legal Matters” section within Note 10 of the unaudited condensed consolidated financial statements within this Quarterly Report on Form 10-Q, which information is incorporated herein by reference, as well as such risks and uncertainties associated with the Company’s ability to regain and maintain compliance with the filing requirements of the SEC and the Nasdaq Stock Market. The risks described in the Annual Report on Form 10-K and in this Form 10-Q are not the only risks the Company faces. Additional risks and uncertainties not currently known to the Company, or that the Company deems to be immaterial, also may have a material adverse impact on the Company’s business, financial condition or results of operations.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

In September 2008, our Board of Directors authorized us to repurchase up to \$5.0 million worth of our common stock in the open market or in privately negotiated transactions. As of April 2013, we completed the repurchase of all \$5.0 million in stock authorized under this plan. In April 2013, our Board of Directors authorized us to repurchase up to an additional \$3.0 million worth of our common stock, and in May 2014, our Board of Directors increased the repurchase authorization by another \$7.0 million. In May 2016, the Board of Directors increased the repurchase authorization by an additional \$5.0 million. During the quarter ended December 31, 2018, we purchased 14,111 shares of our common stock in the open market at prices ranging from \$24.85 to \$25.15 per share. In January 2019, the Board of Directors increased the repurchase authorization by an additional \$10.0 million. During the quarter ended March 31, 2019, we purchased 70,700 shares of our common stock in the open market at prices ranging from \$20.75 to \$24.00 per share. As of March 31, 2019, we have \$11.2 million remaining to purchase additional shares.

Following is a summary of our purchases during the quarter ended March 31, 2019:

| Period | Total Number of Shares (or Units) Purchased | Average Price Paid per Share (or Unit)(2) | Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs(1) | Maximum Number (or Approximate Dollar Value) of Shares (or Units) That May Yet be Purchased Under the Plans or Programs |
|---------------------|--|---|---|---|
| January 1-31, 2019 | 14,100 | \$ 21.61 | 14,100 | \$ 12,480,681 |
| February 1-28, 2019 | 16,799 | \$ 23.99 | 16,799 | \$ 12,077,633 |
| March 1-31, 2019 | 39,801 | \$ 22.57 | 39,801 | \$ 11,179,434 |
| Total | 70,700 | \$ 22.71 | 70,700 | |

(1) All shares were purchased pursuant to the repurchase plans approved by the Board of Directors, as described above.

(2) Prices include any commissions and transaction costs.

Item 6. Exhibits.

| <u>Exhibit No.</u> | <u>Description</u> |
|--------------------|---|
| 3.1 | Articles of Incorporation dated December 9, 1994. (Incorporated by reference from Form SB-2 filed with the SEC on January 11, 1995.) * |
| 3.2 | Certificate of Amendment to Articles of Incorporation dated September 9, 2008. (Incorporated by reference from Definitive Schedule 14A filed with the SEC on July 21, 2008.) * |
| 3.3 | Certificate of Amendment to Articles of Incorporation dated August 6, 2014. (Incorporated by reference from Definitive Schedule 14A filed with the SEC on June 24, 2014.) * |
| 3.4 | Amended and Restated Bylaws. (Incorporated by reference from Form 8-K filed with the SEC on March 16, 2016.) * |
| 4.1 | Consolidated, Amended and Restated Promissory Note for \$62,539,366.08 with Centennial Bank (Incorporated by reference from Form 8-K filed with the SEC on December 19, 2017) * |
| 4.2 | Amended and Restated Promissory Note for \$10,558,311.35 with Centennial Bank (Incorporated by reference from Form 8-K filed with the SEC on December 19, 2017) * |
| 4.3 | Amended and Restated Promissory Note for \$8,147,572.57 with Centennial Bank (Incorporated by reference from Form 8-K filed with the SEC on December 19, 2017) * |
| 10.1 | Employment Agreement with Eric S. Langan. (Incorporated by reference from Form 8-K filed with the SEC on May 4, 2018.) * |
| 10.2 | Employment Agreement with Travis Reese. (Incorporated by reference from Form 8-K filed with the SEC on May 4, 2018.) * |
| 10.3 | Employment Agreement with Phillip K. Marshall. (Incorporated by reference from Form 8-K filed with the SEC on May 4, 2018.) * |
| 10.4 | Loan Agreement between RCI Holdings, Inc. and Centennial Bank (Incorporated by reference from Form 8-K filed with the SEC on December 19, 2017) * |
| 10.5 | Absolute Unconditional and Continuing Guaranty of RCI Hospitality Holdings, Inc. to Centennial Bank (Incorporated by reference from Form 8-K filed with the SEC on December 19, 2017) * |
| 10.6 | Absolute Unconditional and Continuing Guaranty of Eric S. Langan to Centennial Bank (Incorporated by reference from Form 8-K filed with the SEC on December 19, 2017) * |
| 31.1 | Certification of Chief Executive Officer of RCI Hospitality Holdings, Inc. required by Rule 13a-14(1) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Chief Financial Officer of RCI Hospitality Holdings, Inc. required by Rule 13a-14(1) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32 | Certification of Chief Executive Officer and Chief Financial Officer of RCI Hospitality Holdings, Inc. pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and Section 1350 of 18 U.S.C. 63. |
| 101.INS | XBRL Instance Document. |
| 101.SCH | XBRL Taxonomy Extension Schema Document. |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document. |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document. |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document. |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document. |

* Incorporated by reference from our previous filings with the SEC.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

RCI HOSPITALITY HOLDINGS, INC.

Date: September 24, 2019

By: /s/ Eric S. Langan

Eric S. Langan
Chief Executive Officer and President

Date: September 24, 2019

By: /s/ Phillip K. Marshall

Phillip K. Marshall
Chief Financial Officer and Principal Accounting Officer

**CERTIFICATION PURSUANT TO SECTION 302 OF THE
SARBANES-OXLEY ACT OF 2002**

I, Eric S. Langan, Chief Executive Officer and President of RCI Hospitality Holdings, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of RCI Hospitality Holdings, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under my supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under my supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal year that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's independent registered public accounting firm and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: September 24, 2019

By: /s/ Eric S. Langan

Eric S. Langan
Chief Executive Officer and President

**CERTIFICATION PURSUANT TO SECTION 302 OF THE
SARBANES-OXLEY ACT OF 2002**

I, Phillip K. Marshall, Chief Financial Officer of RCI Hospitality Holdings, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of RCI Hospitality Holdings, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under my supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under my supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's independent registered public accounting firm and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: September 24, 2019

By: /s/ Phillip K. Marshall

Phillip K. Marshall

Chief Financial Officer and Principal Accounting Officer

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of RCI Hospitality Holdings, Inc. (the "Company") on Form 10-Q for the fiscal period ended March 31, 2019 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), we, the Chief Executive Officer and the Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that based on our knowledge, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company as of and for the periods covered in the Report.

/s/ Eric S. Langan

Eric S. Langan
Chief Executive Officer
September 24, 2019

/s/ Phillip K. Marshall

Phillip K. Marshall
Chief Financial Officer
September 24, 2019

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to RCI Hospitality Holdings, Inc. and will be retained by RCI Hospitality Holdings, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

The foregoing certification is being furnished to the Securities and Exchange Commission as an exhibit to the Form 10-Q and shall not be considered filed as part of the Form 10-Q.
