
**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, 2020

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 May 8, 2020, 9,125,281 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 maintain compliance with the filing requirements of the SEC and the Nasdaq Stock Market, (vii) the impact of the COVID-19 pandemic, and (viii) 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, 2020</u> (unaudited)	<u>September 30, 2019</u>
ASSETS		
Current assets		
Cash and cash equivalents	\$ 9,825	\$ 14,097
Accounts receivable, net	3,559	6,289
Current portion of notes receivable	675	954
Inventories	2,735	2,598
Prepaid insurance	2,805	5,446
Other current assets	2,343	2,521
Assets held for sale	4,825	2,866
Total current assets	<u>26,767</u>	<u>34,771</u>
Property and equipment, net	182,234	183,956
Operating lease right-of-use assets	26,485	-
Notes receivable, net of current portion	4,087	4,211
Goodwill	47,109	53,630
Intangibles, net	74,251	75,951
Other assets	963	1,118
Total assets	<u>\$ 361,896</u>	<u>\$ 353,637</u>
LIABILITIES AND EQUITY		
Current liabilities		
Accounts payable	\$ 2,805	\$ 3,810
Accrued liabilities	8,671	14,644
Current portion of long-term debt	14,771	15,754
Current portion of operating lease liabilities	1,552	-
Total current liabilities	<u>27,799</u>	<u>34,208</u>
Deferred tax liability, net	20,503	21,658
Long-term debt, net of current portion and debt discount and issuance costs	125,669	127,774
Operating lease liabilities, net of current portion	26,275	-
Other long-term liabilities	374	1,696
Total liabilities	<u>200,620</u>	<u>185,336</u>
Commitments and contingencies (Note 10)		
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; 9,125 and 9,591 shares issued and outstanding as of March 31, 2020 and September 30, 2019, respectively	91	96
Additional paid-in capital	52,829	61,312
Retained earnings	108,584	107,049
Total RCIHH stockholders' equity	<u>161,504</u>	<u>168,457</u>
Noncontrolling interests	(228)	(156)
Total equity	<u>161,276</u>	<u>168,301</u>
Total liabilities and equity	<u>\$ 361,896</u>	<u>\$ 353,637</u>

See accompanying notes to unaudited condensed consolidated financial statements.

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

	For the Three Months Ended March 31,		For the Six Months Ended March 31,	
	2020	2019	2020	2019
Revenues				
Sales of alcoholic beverages	\$ 16,919	\$ 18,486	\$ 37,662	\$ 36,796
Sales of food and merchandise	6,479	6,439	13,926	12,129
Service revenues	14,348	16,979	31,541	34,310
Other	2,680	2,922	5,691	5,614
Total revenues	<u>40,426</u>	<u>44,826</u>	<u>88,820</u>	<u>88,849</u>
Operating expenses				
Cost of goods sold				
Alcoholic beverages sold	3,435	3,790	7,581	7,526
Food and merchandise sold	2,239	2,308	4,792	4,292
Service and other	108	94	185	186
Total cost of goods sold (exclusive of items shown separately below)	5,782	6,192	12,558	12,004
Salaries and wages	12,222	11,908	25,445	24,004
Selling, general and administrative	14,450	14,341	30,981	28,368
Depreciation and amortization	2,257	2,200	4,461	4,253
Other charges (gains), net	8,190	(981)	8,164	(2,078)
Total operating expenses	<u>42,901</u>	<u>33,660</u>	<u>81,609</u>	<u>66,551</u>
Income (loss) from operations	(2,475)	11,166	7,211	22,298
Other income (expenses)				
Interest expense	(2,459)	(2,645)	(4,944)	(5,166)
Interest income	85	75	183	126
Unrealized gain (loss) on equity securities	(62)	77	(134)	(370)
Income (loss) before income taxes	(4,911)	8,673	2,316	16,888
Income tax expense (benefit)	(1,418)	1,930	175	3,741
Net income (loss)	(3,493)	6,743	2,141	13,147
Net loss (income) attributable to noncontrolling interests	41	(8)	41	(68)
Net income (loss) attributable to RCIHH common stockholders	<u>\$ (3,452)</u>	<u>\$ 6,735</u>	<u>\$ 2,182</u>	<u>\$ 13,079</u>
Earnings (loss) per share				
Basic and diluted	\$ (0.37)	\$ 0.70	\$ 0.24	\$ 1.35
Weighted average number of common shares outstanding				
Basic and diluted	9,225	9,679	9,274	9,696
Dividends per share	\$ 0.04	\$ 0.03	\$ 0.07	\$ 0.06

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Common Stock		Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock		Noncontrolling Interests	Total Equity
	Number of Shares	Amount				Number of Shares	Amount		
Balance at September 30, 2019	9,591	\$ 96	\$ 61,312	\$ 107,049	\$ -	-	\$ -	\$ (156)	\$ 168,301
Purchase of treasury shares	-	-	-	-	-	(333)	(6,441)	-	(6,441)
Canceled treasury shares	(333)	(3)	(6,438)	-	-	333	6,441	-	-
Payment of dividends	-	-	-	(279)	-	-	-	-	(279)
Payment to noncontrolling interest	-	-	-	-	-	-	-	(10)	(10)
Net income	-	-	-	5,634	-	-	-	-	5,634
Balance at December 31, 2019	9,258	\$ 93	\$ 54,874	\$ 112,404	\$ -	-	\$ -	\$ (166)	\$ 167,205
Purchase of treasury shares	-	-	-	-	-	(133)	(2,047)	-	(2,047)
Canceled treasury shares	(133)	(2)	(2,045)	-	-	133	2,047	-	-
Payment of dividends	-	-	-	(368)	-	-	-	-	(368)
Payment to noncontrolling interest	-	-	-	-	-	-	-	(21)	(21)
Net loss	-	-	-	(3,452)	-	-	-	(41)	(3,493)
Balance at March 31, 2020	9,125	\$ 91	\$ 52,829	\$ 108,584	\$ -	-	\$ -	\$ (228)	\$ 161,276
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

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,	
	2020	2019
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 2,141	\$ 13,147
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,461	4,253
Deferred income tax expense (benefit)	(1,155)	1,131
Gain on sale of businesses and assets	(36)	(2,197)
Impairment of assets	8,210	-
Unrealized loss on equity securities	134	370
Amortization of debt discount and issuance costs	129	202
Deferred rent	-	189
Noncash lease expense	825	-
Gain on insurance	(33)	-
Changes in operating assets and liabilities:		
Accounts receivable	1,917	1,727
Inventories	(137)	(182)
Prepaid insurance, other current and other assets	2,840	3,550
Accounts payable, accrued and other liabilities	(7,315)	(1,219)
Net cash provided by operating activities	<u>11,981</u>	<u>20,971</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sale of businesses and assets	105	2,866
Proceeds from insurance	945	-
Proceeds from notes receivable	403	68
Issuance of note receivable	-	(420)
Payments for property and equipment and intangible assets	(5,323)	(13,902)
Acquisition of businesses, net of cash acquired	-	(13,500)
Net cash used in investing activities	<u>(3,870)</u>	<u>(24,888)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from long-term debt	880	10,296
Payments on long-term debt	(4,097)	(13,287)
Purchase of treasury stock	(8,488)	(1,961)
Payment of dividends	(647)	(582)
Payment of loan origination costs	-	(20)
Distribution to noncontrolling interests	(31)	-
Net cash used in financing activities	<u>(12,383)</u>	<u>(5,554)</u>
NET DECREASE IN CASH AND CASH EQUIVALENTS	(4,272)	(9,471)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	14,097	17,726
CASH AND CASH EQUIVALENTS AT END OF PERIOD	<u>\$ 9,825</u>	<u>\$ 8,255</u>
CASH PAID DURING PERIOD FOR:		
Interest (net of amounts capitalized of \$155 and \$324, respectively)	\$ 4,891	\$ 5,173
Income taxes	<u>\$ 2,105</u>	<u>\$ 319</u>
Noncash investing and financing transactions:		
Notes receivable received as proceeds from sale of assets	\$ -	\$ 625
Operating lease right-of-use assets established upon adoption of ASC 842	\$ 27,310	\$ -
Deferred rent liabilities reclassified upon adoption of ASC 842	\$ 1,241	\$ -
Operating lease liabilities established upon adoption of ASC 842	\$ 28,551	\$ -
Unpaid liabilities on capital expenditures	\$ 21	\$ -

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.

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.

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.

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 accompanying notes to unaudited condensed consolidated financial statements.

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, 2019 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, 2019 included in the Company’s Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on February 13, 2020. 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, 2020 are not necessarily indicative of the results that may be expected for the year ending September 30, 2020.

2. Recent Accounting Standards and Pronouncements

In February 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“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 interim and annual periods beginning after December 15, 2018. Early adoption is permitted. In July 2018, the FASB issued ASU 2018-11 providing for certain practical expedients in the implementation of ASU 2016-02. The guidance requires the use of a modified retrospective approach. We adopted ASU 2016-02 and related amendments as of October 1, 2019 and elected the package of practical expedients permitted under the transition guidance within the new standard, which among other things, allows us to retain historical lease classification, as well as relief from reviewing expired and existing contracts to determine if they contain leases. Our adoption of the new leasing standard resulted in an increase of \$27.3 million in our total assets as of October 1, 2019 due to the recognition of operating lease right-of-use assets net of the reclassification of deferred rent liability of \$1.2 million and an increase in total liabilities due to the recognition of a \$28.6 million operating lease liabilities. Our adoption of ASC 842 did not have an impact on our consolidated statements of operations and cash flows, except for additional required disclosures. See additional disclosures in Note 14.

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. This ASU requires, among other things, the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. ASU 2016-13 replaces the existing incurred loss impairment model with an expected loss model which requires the use of forward-looking information to calculate credit loss estimates. It also eliminates the concept of other-than-temporary impairment and requires credit losses related to available-for-sale debt securities to be recorded through an allowance for credit losses rather than as a reduction in the amortized cost basis of the securities. These changes will result in earlier recognition of credit losses. The ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early application will be permitted for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. We are still evaluating the impact of this ASU, including all related updates, on the Company’s consolidated financial statements.

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

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 accumulated other comprehensive income (“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 adopted ASU 2018-02 as of October 1, 2019. Our adoption of this guidance did not have an 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.

In December 2019, the FASB issued ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*. This ASU simplifies accounting for income taxes by removing the following exceptions: (1) exception to the incremental approach for intraperiod tax allocation, (2) exceptions to accounting for basis differences when there are ownership changes in foreign investments, and (3) exception in interim period income tax accounting for year-to-date losses that exceed anticipated losses. The ASU also improves financial statement preparers' application of income tax related guidance for franchise taxes that are partially based on income; transactions with a government that result in a step up in the tax basis of goodwill; separate financial statements of legal entities that are not subject to tax; and enacted changes in tax laws in interim periods. The ASU is effective for public business entities for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years. Early adoption is permitted for public business entities for periods for which financial statements have not been issued. An entity that elects early adoption in an interim period should reflect any adjustments as of the beginning of the annual period that includes that interim period. Additionally, an entity that elects early adoption should adopt all the amendments in the same period. 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)

3. Liquidity and Impact of COVID-19 Pandemic

In March 2020, President Donald Trump declared the coronavirus disease 2019 (“COVID-19”) pandemic as a national public health emergency. COVID-19 is the disease caused by a novel strain of a coronavirus that originated from Wuhan, China in November 2019. The declaration resulted in a significant reduction in customer traffic in our clubs and restaurants due to changes in consumer behavior as social distancing practices, dining room closures and other restrictions that were mandated or encouraged by federal, state and local governments, and as of March 18, 2020, we temporarily closed all of our clubs and restaurants.

The closure of our clubs and restaurants caused by the COVID-19 pandemic has presented operational challenges. Our strategy is to open locations in accordance with local and state guidelines and it is too early to know when and if they will generate positive cash flows for us. Depending on the timing and number of locations we get open, and their ability to generate positive cash flow, we may need to borrow funds to meet our obligations or consider selling certain assets. The COVID-19 pandemic is adversely affecting the availability of liquidity generally in the credit markets, and there can be no guarantee that additional liquidity will be readily available or available on favorable terms, especially the longer the COVID-19 pandemic lasts.

To augment an expected decline in operating cash flows caused by the COVID-19 pandemic, we instituted the following measures:

- Arranged for deferment of principal and interest payment on certain of our debts;
- Furloughed employees working at our clubs and restaurants, except for a limited number of managers;
- Pay cut for all remaining salaried and hourly employees and deferral of board of director compensation;
- Deferred or modified certain fixed monthly expenses such as insurance, rent, and taxes, among others;
- Canceled certain non-essential expenses such as advertising, cable, pest control, point-of-sale system support, and investor relations coverage, among others.

On May 8, 2020, the Company received approval and funding under the Paycheck Protection Program (“PPP”) of the CARES Act for its restaurants, shared service entity and lounge. See Note 9. Ten of our restaurant subsidiaries received amounts ranging from \$271,000 to \$579,000 for an aggregate amount of \$4.2 million; our shared-services subsidiary received \$1.1 million; and one of our lounges received \$124,000. None of our adult nightclub and other non-core business subsidiaries received funding under the PPP.

As of the release of this report, we do not know the extent and duration of the impact of COVID-19 on our businesses due to the uncertainty about the spread of the virus. Lower sales, as caused by social distancing guidelines, could lead to adverse financial results. However, we will continually monitor and evaluate the situation and will determine any further measures to be instituted.

Also as of the release of this report, we have ten locations in Texas that have partially reopened with 25% occupancy requirement.

Valuation of Goodwill, Indefinite-Lived Intangibles and Long-Lived tangible Assets

We consider the COVID-19 pandemic as a triggering event in the assessment of recoverability of the goodwill, indefinite-lived intangibles and long-lived tangible assets in our clubs and restaurants that are affected. We evaluated forecasted cash flows considering future assumed impact of COVID-19 pandemic on sales. Based on our evaluation, we determined our assets are impaired in a total amount of approximately \$8.2 million comprised of \$6.5 million in goodwill, \$1.4 million in SOB licenses, and \$302,000 in property and equipment.

4. Revenues

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 accompanying unaudited condensed consolidated statements of operations. 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 lease revenues are recognized when earned (recognized over time) and are more appropriately covered by guidance under ASC Topic 842, *Leases* (ASC 840 in prior year). See Note 14.

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Revenues, as disaggregated by revenue type, timing of recognition, and reportable segment (see also Note 12), are shown below (in thousands):

	Three Months Ended March 31, 2020				Three Months Ended March 31, 2019			
	Nightclubs	Bombshells	Other	Total	Nightclubs	Bombshells	Other	Total
Sales of alcoholic beverages	\$ 11,860	\$ 5,059	\$ -	\$ 16,919	\$ 14,148	\$ 4,338	\$ -	\$ 18,486
Sales of food and merchandise	2,799	3,680	-	6,479	3,293	3,146	-	6,439
Service revenues	14,290	58	-	14,348	16,943	36	-	16,979
Other revenues	2,418	6	256	2,680	2,663	7	252	2,922
	<u>\$ 31,367</u>	<u>\$ 8,803</u>	<u>\$ 256</u>	<u>\$ 40,426</u>	<u>\$ 37,047</u>	<u>\$ 7,527</u>	<u>\$ 252</u>	<u>\$ 44,826</u>
Recognized at a point in time	\$ 30,977	\$ 8,803	\$ 252	\$ 40,032	\$ 36,582	\$ 7,527	\$ 238	\$ 44,347
Recognized over time	390*	-	4	394	465*	-	14	479
	<u>\$ 31,367</u>	<u>\$ 8,803</u>	<u>\$ 256</u>	<u>\$ 40,426</u>	<u>\$ 37,047</u>	<u>\$ 7,527</u>	<u>\$ 252</u>	<u>\$ 44,826</u>

	Six Months Ended March 31, 2020				Six Months Ended March 31, 2019			
	Nightclubs	Bombshells	Other	Total	Nightclubs	Bombshells	Other	Total
Sales of alcoholic beverages	\$ 26,544	\$ 11,118	\$ -	\$ 37,662	\$ 28,950	\$ 7,846	\$ -	\$ 36,796
Sales of food and merchandise	6,063	7,863	-	13,926	6,500	5,629	-	12,129
Service revenues	31,384	157	-	31,541	34,256	54	-	34,310
Other revenues	5,235	15	441	5,691	5,069	11	534	5,614
	<u>\$ 69,226</u>	<u>\$ 19,153</u>	<u>\$ 441</u>	<u>\$ 88,820</u>	<u>\$ 74,775</u>	<u>\$ 13,540</u>	<u>\$ 534</u>	<u>\$ 88,849</u>
Recognized at a point in time	\$ 68,411	\$ 19,153	\$ 430	\$ 87,994	\$ 73,974	\$ 13,540	\$ 505	\$ 88,019
Recognized over time	815*	-	11	826	801*	-	29	830
	<u>\$ 69,226</u>	<u>\$ 19,153</u>	<u>\$ 441</u>	<u>\$ 88,820</u>	<u>\$ 74,775</u>	<u>\$ 13,540</u>	<u>\$ 534</u>	<u>\$ 88,849</u>

* Lease revenue (included in Other Revenues) as covered by ASC Topic 842 in the current year (and ASC Topic 840 in the prior year). 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 (in thousands):

	Balance at September 30, 2019	Consideration Received	Recognized in Revenue	Balance at March 31, 2020
Ad revenue	\$ 76	\$ 355	\$ (303)	\$ 128
Expo revenue	-	351	-	351
Other	7	12	(17)	2
	<u>\$ 83</u>	<u>\$ 718</u>	<u>\$ (320)</u>	<u>\$ 481</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 operations.

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5. Selected Account Information

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

	March 31, 2020	September 30, 2019
Insurance	\$ 1,700	\$ 4,937
Sales and liquor taxes	2,460	3,086
Payroll and related costs	1,372	2,892
Property taxes	829	1,675
Patron tax	480	595
Unearned revenues	481	83
Lawsuit settlement	75	115
Other	1,274	1,261
	<u>\$ 8,671</u>	<u>\$ 14,644</u>

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

	For the Three Months Ended March 31,		For the Six Months Ended March 31,	
	2020	2019	2020	2019
Taxes and permits	\$ 2,240	\$ 2,370	\$ 4,914	\$ 4,551
Advertising and marketing	1,907	2,070	4,317	4,218
Supplies and services	1,390	1,465	2,924	2,921
Insurance	1,473	1,402	2,956	2,755
Accounting and professional fees	1,311	1,278	2,509	1,928
Lease	1,023	957	2,053	1,976
Charge card fees	845	886	1,891	1,819
Legal	1,072	773	2,268	1,831
Utilities	798	762	1,693	1,506
Security	749	756	1,597	1,465
Repairs and maintenance	652	721	1,449	1,308
Other	990	901	2,410	2,090
	<u>\$ 14,450</u>	<u>\$ 14,341</u>	<u>\$ 30,981</u>	<u>\$ 28,368</u>

6. Assets Held for Sale

As of September 30, 2019, the Company had two real estate properties for sale. The aggregate estimated fair value of the properties less cost to sell as of September 30, 2019 was approximately \$2.9 million and was reclassified to assets held for sale in the Company's consolidated balance sheet. The assets were measured at the carrying value as adjusted for depreciation, which was lower than the fair value at the date reclassified.

During the six months ended March 31, 2020, the Company classified as held-for-sale another real estate property. The aggregate estimated fair value of the property less cost to sell was \$1.9 million. As of March 31, 2020, the Company has a total of three real estate properties held for sale with a total value of \$4.8 million.

The Company expects the properties held for sale, which are primarily comprised of land and buildings, to be sold within 12 months through property listings by our real estate brokers.

Liabilities associated with held-for-sale assets amounting to \$1.2 million and \$0 as of March 31, 2020 and September 30, 2019, respectively, are included in current portion of long-term debt in our unaudited consolidated balance sheets. The gain or loss on the sale of properties held for sale is included in other charges/gains, net in the unaudited condensed consolidated statements of operations.

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7. Long-term Debt

In December 2019, the Company amended the \$5.0 million short-term note payable related to the Scarlett's acquisition in May 2017, which had a balance of \$3.0 million as of the amendment date, extending the maturity date to October 1, 2022. The amendment did not have an impact in the Company's results of operations and cash flows.

In February 2020, in relation to a \$4.0 million 12% note payable earlier refinanced on August 15, 2018, the Company restructured the note with a private lender by executing a 12% 10-year note payable \$57,388 monthly, including interest, starting March 2020. The restructured note eliminates a scheduled balloon principal payment of \$4.0 million in August 2021. The refinancing did not have an impact in the Company's results of operations and cash flows.

In February 2020, in relation to a \$9.9 million 12% note payable that was partially paid during the December 2017 Refinancing Loan, the Company restructured the note, which had a balance of \$5.2 million as of the amendment date, by executing a 12% 10-year note payable \$74,515 monthly, including interest, starting March 2020. The restructured note eliminates a scheduled balloon principal payment of \$3.8 million in October 2021. As a result of the refinancing, the Company wrote off approximately \$25,400 in unamortized debt issuance cost as interest expense in the unaudited condensed consolidated statement of operations for the quarter ended March 31, 2020.

Included in the balance of long-term debt as of March 31, 2020 and September 30, 2019 is a \$500,000 note borrowed from a related party (see Note 13) and three notes totaling \$600,000 borrowed from two non-officer employees 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 groups.

Future maturities of long-term debt as of March 31, 2020 are as follows: \$14.8 million, \$11.7 million, \$11.6 million, \$8.1 million, \$8.4 million and \$87.2 million for the twelve months ending March 31, 2021, 2022, 2023, 2024, 2025, and thereafter, respectively. Of the maturity schedule mentioned above, \$6.1 million, \$2.8 million, \$3.8 million, \$0, \$0 and \$56.0 million, respectively, relate to scheduled balloon payments.

On May 1, 2020, the Company negotiated extensions to November 1, 2020 on \$1,740,000 of \$2,040,000 of notes to individuals that were due on May 1, 2020. The Company paid \$300,000 to certain lenders and received \$200,000 in new debt from existing lenders and their affiliates. The aggregate amount of debt due on these notes on November 1, 2020 is now \$1,940,000.

8. Equity

During the three and six months ended March 31, 2020, the Company purchased and retired 132,719 and 465,390 common shares, respectively, at a cost of approximately \$2.0 and \$8.5 million, respectively. The Company paid \$0.04 and \$0.07 per share cash dividends during the three and six months ended March 31, 2020 totaling approximately \$368,000 and \$647,000, respectively.

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.

On February 6, 2020, the Company's Board of Directors authorized an additional \$10.0 million to repurchase the Company's common stock. As of May 8, 2020, the Company has \$11.8 million remaining to purchase additional shares under its share repurchase program.

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9. Income Taxes

Income taxes were \$1.4 million benefit and \$175,000 expense during the three and six months ended March 31, 2020, respectively, compared to income tax expense of \$1.9 million and \$3.7 million during the three and six months ended March 31, 2019, respectively. The effective income tax rate was a 28.9% benefit and a 7.6% expense during the three and six months ended March 31, 2020, respectively, compared to expense rates of 22.3% and 22.2% during the three and six months ended March 31, 2019, respectively. Our effective tax rate for both years is affected by state taxes, permanent differences, and tax credits, including the FICA tip credit.

The Company or one of its subsidiaries file 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. Tax years 2014 through 2017 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.

The Company accounts for uncertain tax positions pursuant to ASC Topic 740, *Income Taxes*. As of March 31, 2020 and September 30, 2019, the liability for uncertain tax positions was \$0 and \$0, respectively. 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 operations.

On March 27, 2020, President Trump signed the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act") into law. As a result of this, additional avenues of relief may be available to workers and families through enhanced unemployment insurance provisions and to small businesses through programs administered by the Small Business Administration. The CARES Act includes, among other items, provisions relating to payroll tax credits and deferrals, net operating loss carryback periods, alternative minimum tax credits and technical corrections to tax depreciation methods for qualified improvement property. The Company is currently evaluating the impact of the provisions of the CARES Act. The CARES Act also established a Paycheck Protection Program ("PPP"), whereby certain small businesses are eligible for a loan to fund payroll expenses, rent, and related costs. The loan may be forgiven if the funds are used for payroll and other qualified expenses. The Company has submitted its application for a PPP loan and on May 8, 2020 has received approval and funding for its restaurants, shared service entity and lounge. Ten of our restaurant subsidiaries received amounts ranging from \$271,000 to \$579,000 for an aggregate amount of \$4.2 million; our shared-services subsidiary received \$1.1 million; and one of our lounges received \$124,000. None of our adult nightclub and other non-core business subsidiaries received funding under the PPP. There is no certainty that the loan will qualify for forgiveness.

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 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 aggregate balance of Patron Tax settlement liability, which is included in long-term debt in the consolidated balance sheets, amounted to \$2.8 million and \$3.4 million as of March 31, 2020 and September 30, 2019, respectively.

A declaratory judgment action was brought by five operating subsidiaries of the Company 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. On March 6, 2020, the U.S. District Court for the Western District of Texas, Austin Division, ruled that the Texas Patron Tax is unconstitutional as it has been applied and enforced by the Comptroller. The State of Texas has filed a Notice of Appeal. We will continue to vigorously defend the matter through the appeals process.

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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.

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 have been filed with the Receiver before the close of business on January 16, 2015 and that all pending lawsuits involving IIC as the insurer were 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, 2020, 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 moved to consolidate the purported class actions. On January 10, 2020 an order consolidating the Hoffman, Grossman, and Gu cases was entered by the Court. The consolidated case is styled In re RCI Hospitality Holdings, Inc., No. 4:19-cv-01841. On February 24, 2020, the plaintiffs in the consolidated case filed an Amended Class Action Complaint, continuing to allege violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and 10b-5 promulgated thereunder. In addition to naming the Company, Eric Langan, and Phil Marshall, the amended complaint also adds director Nour-Dean Anakar and former director Steven Jenkins as defendants. On April 24, 2020, the Company and the individual defendants moved to dismiss the amended complaint for failure to state a claim upon which relief can be granted. The plaintiff’s response to the motion is currently due June 23, 2020. The Company and the individual defendants will have the opportunity to file a reply in support of their motion by July 23, 2020. The Company intends to continue to vigorously defend against this action. This action is in its preliminary phase, and a potential loss cannot yet be estimated.

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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, Luke Lirot, Travis Reese, former director Steven Jenkins, 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 has implemented 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 and included in other current assets in both consolidated balance sheets as of March 31, 2020 and September 30, 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. It is anticipated that a new trial will occur at some point in the future. JAI Phoenix 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, 2019, 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, 2020 total approximately \$0 and \$24,000, respectively, while for the three and six months ended March 31, 2019 total \$84,000 and \$144,000, respectively. As of March 31, 2020 and September 30, 2019, the Company has accrued \$75,000 and \$115,000 in accrued liabilities, respectively, related to settlement of lawsuits.

11. Acquisition

On November 5, 2019, we announced that our subsidiaries had signed definitive agreements to acquire the assets and related real estate of a well-established, top gentlemen’s club located in the Northeast Corridor for \$15.0 million. The agreements terminated prior to closing. We provided the sellers notice of the termination in April 2020.

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12. 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.

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,	
	2020	2019	2020	2019
Revenues				
Nightclubs	\$ 31,367	\$ 37,047	\$ 69,226	\$ 74,775
Bombshells	8,803	7,527	19,153	13,540
Other	256	252	441	534
	<u>\$ 40,426</u>	<u>\$ 44,826</u>	<u>\$ 88,820</u>	<u>\$ 88,849</u>
Income (loss) from operations				
Nightclubs	\$ 2,314	\$ 15,078	\$ 16,090	\$ 30,465
Bombshells	690	738	2,263	857
Other	(178)	(176)	(385)	(295)
General corporate	(5,301)	(4,474)	(10,757)	(8,729)
	<u>\$ (2,475)</u>	<u>\$ 11,166</u>	<u>\$ 7,211</u>	<u>\$ 22,298</u>
Depreciation and amortization				
Nightclubs	\$ 1,486	\$ 1,467	\$ 2,956	\$ 2,974
Bombshells	456	339	873	631
Other	104	106	208	210
General corporate	211	288	424	438
	<u>\$ 2,257</u>	<u>\$ 2,200</u>	<u>\$ 4,461</u>	<u>\$ 4,253</u>
Capital expenditures				
Nightclubs	\$ 526	\$ 647	\$ 2,858	\$ 1,094
Bombshells	612	5,788	2,337	9,797
Other	-	9	-	18
General corporate	127	163	128	2,993
	<u>\$ 1,265</u>	<u>\$ 6,607</u>	<u>\$ 5,323</u>	<u>\$ 13,902</u>
		<u>March 31, 2020</u>		<u>September 30, 2019</u>
Total assets				
Nightclubs	\$	281,080	\$	274,071
Bombshells		48,271		44,144
Other		1,723		1,773
General corporate		30,822		33,649
	<u>\$</u>	<u>361,896</u>	<u>\$</u>	<u>353,637</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.

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, 2020 and September 30, 2019 is \$86.0 million and \$86.8 million, respectively.

Included in the \$2.35 million borrowing on November 1, 2018 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 Nottingham Creations (formerly 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. Nottingham Creations (as was Sherwood Forest) is owned by a brother of Eric Langan. Amounts billed to us for goods and services provided by Nottingham Creations and Sherwood Forest were \$53,556 and \$72,809 during the three and six months ended March 31, 2020, respectively, and \$98,072 and \$107,815 during the three and six months ended March 31, 2019, respectively. As of March 31, 2020 and September 30, 2019, we owed Nottingham Creations and Sherwood Forest \$13,705 and \$6,588, 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 2020 and 2019. A son-in-law of Eric Langan owns a noncontrolling interest in TW Mechanical. Amounts billed by TW Mechanical to the third-party general contractor were \$18,758 and \$30,585 for the three and six months ended March 31, 2020, respectively, and \$359,500 and \$435,800 for the three and six months ended March 31, 2019, respectively. Amounts billed directly to the Company were \$24,416 and \$26,241 for the three and six months ended March 31, 2020, respectively, and \$206 and \$206 for the three and six months ended March 31, 2019, respectively. As of March 31, 2020 and September 30, 2019, the Company owed TW Mechanical \$20,401 and \$0, respectively, in unpaid direct billings.

RCI HOSPITALITY HOLDINGS, INC.
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(Unaudited)

14. Leases

The Company leases certain facilities and equipment under operating leases. Under ASC 840, lease expense for the Company's operating leases, which generally have escalating rentals over the term of the lease, is recorded using the straight-line method over the initial lease term whereby an equal amount of lease expense is attributed to each period during the term of the lease, regardless of when actual payments are made. Generally, this results in lease expense in excess of cash payments during the early years of a lease and lease expense less than cash payments in the later years. The difference between lease expense recognized and actual lease payments is accumulated and included in other long-term liabilities in the consolidated balance sheets.

Included in lease expense in our unaudited condensed consolidated statements of operations (see Note 5) were lease payments for a house that the Company's CEO rented to the Company for corporate housing for its out-of-town Bombshells management and trainers, of which lease expense totaled \$0 and \$19,500 for the three and six months ended March 31, 2020, respectively, and \$19,500 and \$39,000 for the three and six months ended March 31, 2019. This lease terminated on December 31, 2019.

Undiscounted future minimum annual lease obligations as of September 30, 2019 are as follows (in thousands):

2020	\$	3,237
2021		3,154
2022		3,057
2023		2,889
2024		2,850
Thereafter		21,038
Total future minimum lease obligations	\$	36,225

Included in the future minimum lease obligations are billboard and outdoor sign leases. These leases were recorded as advertising and marketing expenses, and included in selling, general and administrative expenses in our unaudited condensed consolidated statements of operations. Under ASC 840, we recorded lease expense amounting to \$957,000 and \$2.0 million during the three and six months ended March 31, 2019.

The Company adopted ASC 842 as of October 1, 2019. The Company's adoption of ASC 842 included renewal or termination options for varying periods which we deemed reasonably certain to exercise. This determination is based on our consideration of certain economic, strategic and other factors that we evaluate at lease commencement date and reevaluate throughout the lease term.

Some leasing arrangements require variable payments that are dependent on usage or may vary for other reasons, such as payments for insurance and tax payments. The variable portion of lease payments is not included in our right-of-use assets or lease liabilities. Rather, variable payments, other than those dependent upon an index or rate, are expensed when the obligation for those payments is incurred and are included in lease expenses recorded in selling, general and administrative expenses in our unaudited condensed consolidated statement of operations.

We have elected to apply the short-term lease exception for all underlying asset classes, which mainly includes equipment leases. That is, leases with a term of 12 months or less are not recognized on the balance sheet, but rather expensed on a straight-line basis over the lease term. We do not include significant restrictions or covenants in our lease agreements, and residual value guarantees are generally not included within our operating leases.

Our adoption of ASC 842 did not have a material impact on our lease revenue accounting as a lessor. See Note 4.

Future maturities of lease liabilities as of March 31, 2020 are as follows (in thousands):

	<u>Principal Payments</u>	<u>Interest Payments</u>	<u>Total Payments</u>
April 2020 – March 2021	\$ 1,552	\$ 1,641	\$ 3,193
April 2021 – March 2022	1,692	1,543	3,235
April 2022 – March 2023	1,728	1,438	3,166
April 2023 – March 2024	1,706	1,336	3,042
April 2024 – March 2025	1,860	1,229	3,089
Thereafter	19,289	5,992	25,281
	<u>\$ 27,827</u>	<u>\$ 13,179</u>	<u>\$ 41,006</u>

Total lease expense, under ASC 842, was included in selling, general and administrative expenses in our unaudited condensed consolidated statement of operations, except for sublease income which was included in other revenue, for the three and six months ended March 31, 2020 as follows (in thousands):

	<u>Three Months Ended March 31, 2020</u>	<u>Six Months Ended March 31, 2020</u>
Operating lease expense – fixed payments	\$ 838	\$ 1,680
Variable lease expense	65	130
Short-term equipment and other lease expense (includes \$145 and \$291 recorded in advertising and marketing, and \$100 and \$225 recorded in repairs and maintenance for the three and six months ended March 31, 2020, respectively; see Note 5)	365	759

Sublease income		(4)		(6)
Total lease expense, net	\$	1,264	\$	2,563
Other information:				
Operating cash outflows from operating leases	\$	1,207	\$	2,462
Weighted average remaining lease term				13 years
Weighted average discount rate				6.1%

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, 2019.

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, 2020, we operated a total of 48 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.

Pre-COVID-19 Financial Performance

During our first quarter ended December 31, 2019, total revenues were \$4.4 million, or 9.9%, higher than the same quarter in the prior year. Consolidated same-store sales were up by 0.7%. During the first two months of the second quarter, our consolidated same-store sales were up by 12.4%, giving us a cumulative five-month same-store sales increase of 5.3%. With the outbreak of the coronavirus and COVID-19 national emergency guidelines put in place, we experienced a significant downturn in sales brought about by the temporary closure of all of our clubs and restaurants as of March 18, 2020.

Impact of COVID-19 Pandemic

After the stay-at-home order and social distancing guidelines were put into place, our total revenues for the full six-month period ended March 31, 2020 went flat versus last year. Though we earn no revenues from our core businesses during the period of closures, we continue to incur expenses. To alleviate our cash flow situation, we instituted the following measures:

- Arranged for deferment of principal and interest payment on certain of our debts;
- Furloughed employees working at our clubs and restaurants, except for a limited number of managers;
- Pay cut for all remaining salaried and hourly employees and deferral of board of director compensation;
- Deferred or modified certain fixed monthly expenses such as insurance, rent, and taxes, among others;
- Canceled certain non-essential expenses such as advertising, cable, pest control, point-of-sale-system support, and investor relations coverage, among others.

As of the release of this report, we do not know the extent and duration of the impact of COVID-19 on our businesses due to the uncertainty about the spread of the virus. Lower sales, as caused by social distancing guidelines, could lead to adverse financial results. However, we will continually monitor and evaluate the situation and will determine any further measures to be instituted.

Also see the risk factor in “Item 1A. Risk Factors” regarding risks and uncertainties associated with the COVID-19 pandemic.

Critical Accounting Policies and Estimates

The preparation of the unaudited condensed 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, 2019 filed with the SEC on February 13, 2020.

We adopted ASC 842, *Leases*, as of October 1, 2019. Our adoption of ASC 842 resulted in an increase of \$27.3 million in our total assets as of the adoption date due to the recognition of operating lease right-of-use assets net of the reclassification of deferred rent liability of \$1.2 million and an increase in total liabilities due to the recognition of a \$28.6 million operating lease liabilities.

During the three and six months ended March 31, 2020, 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 of the Company during the three months ended March 31, 2020 are as follows:

Second Quarter 2020

- Total revenues were \$40.4 million compared to \$44.8 million during the comparable prior-year period, a 9.8% decrease (Nightclubs revenue of \$31.4 million compared to \$37.0 million, a 15.3% decrease; and Bombshells revenue of \$8.8 million compared to \$7.5 million, a 17.0% increase)
- Consolidated same-store sales decreased by 14.7% (14.8% decrease for Nightclubs and 13.8% decrease for Bombshells)
- Basic and diluted loss per share of \$0.37 compared to basic and diluted earnings per share ("EPS") of \$0.70 (non-GAAP diluted EPS* of \$0.47 compared to \$0.63, a 25.0% decrease)
- Net cash provided by operating activities of \$1.7 million compared to \$9.5 million during the comparable prior-year period, an 82.1% decrease (free cash flow* of \$0.6 million compared to \$8.8 million, a 93.0% decrease)

Year-to-Date 2020

- Total revenues were \$88.8 million compared to \$88.8 million during the comparable prior-year period, flat as compared to prior year (Nightclubs revenue of \$69.2 million compared to \$74.8 million, a 7.4% decrease; and Bombshells revenue of \$19.2 million compared to \$13.5 million, a 41.5% increase)
- Consolidated same-store sales decreased by 7.3% (8.4% decrease for Nightclubs and 0.7% increase for Bombshells)
- Basic and diluted EPS of \$0.24 compared to \$1.35, an 82.2% decrease (non-GAAP diluted EPS* of \$1.09 compared to \$1.24, an 11.8% decrease)
- Net cash provided by operating activities of \$12.0 million compared to \$21.0 million during the comparable prior-year period, a 42.9% decrease (free cash flow* of \$9.9 million compared to \$19.9 million, a 50.3% decrease)

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

Three Months Ended March 31, 2020 Compared to Three Months Ended March 31, 2019

The following table summarizes our results of operations for the three months ended March 31, 2020 and 2019 (dollars in thousands):

	For the Three Months Ended				Increase (Decrease)	
	March 31, 2020		March 31, 2019		Amount	%
	Amount	% of Revenues	Amount	% of Revenues		
Revenues						
Sales of alcoholic beverages	\$ 16,919	41.9%	\$ 18,486	41.2%	\$ (1,567)	(8.5)%
Sales of food and merchandise	6,479	16.0%	6,439	14.4%	40	0.6%
Service revenues	14,348	35.5%	16,979	37.9%	(2,631)	(15.5)%
Other	2,680	6.6%	2,922	6.5%	(242)	(8.3)%
Total revenues	40,426	100.0%	44,826	100.0%	(4,400)	(9.8)%
Operating expenses						
Cost of goods sold						
Alcoholic beverages sold	3,435	20.3%	3,790	20.5%	(355)	(9.4)%
Food and merchandise sold	2,239	34.6%	2,308	35.8%	(69)	(3.0)%
Service and other	108	0.6%	94	0.5%	14	14.9%
Total cost of goods sold (exclusive of items shown separately below)	5,782	14.3%	6,192	13.8%	(410)	(6.6)%
Salaries and wages	12,222	30.2%	11,908	26.6%	314	2.6%
Selling, general and administrative	14,450	35.7%	14,341	32.0%	109	0.8%
Depreciation and amortization	2,257	5.6%	2,200	4.9%	57	2.6%
Other charges (gains), net	8,190	20.3%	(981)	(2.2)%	9,171	934.9%
Total operating expenses	42,901	106.1%	33,660	75.1%	9,241	27.5%
Income (loss) from operations	(2,475)	(6.1)%	11,166	24.9%	(13,641)	(122.2)%
Other income (expenses)						
Interest expense	(2,459)	(6.1)%	(2,645)	(5.9)%	(186)	(7.0)%
Interest income	85	0.2%	75	0.2%	10	13.3%
Unrealized gain (loss) on equity securities	(62)	(0.2)%	77	0.2%	(139)	(180.5)%
Income (loss) before income taxes	(4,911)	(12.1)%	8,673	19.3%	(13,584)	(156.6)%
Income tax expense (benefit)	(1,418)	(3.5)%	1,930	4.3%	(3,348)	(173.5)%
Net income (loss)	\$ (3,493)	(8.6)%	\$ 6,743	15.0%	\$ (10,236)	(151.8)%

* 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 decreased by \$4.4 million, or 9.8%, due primarily to lost sales caused by the COVID-19 pandemic in March 2020. Consolidated same-store sales during the quarter decreased by 14.7% (Nightclubs decreased by 14.8% while Bombshells decreased by 13.8%). Prior to the stay-at-home and social distancing guidelines imposed by the federal, state and local governments, during the first ten weeks of the quarter, consolidated same-store sales was up by 5.3% (Nightclubs increased by 5.6% while Bombshells increased by 3.6%).

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

	For the Three Months Ended March 31,	
	2020	2019
Nightclubs	\$ 31,367	\$ 37,047
Bombshells	8,803	7,527
Other	256	252
	<u>\$ 40,426</u>	<u>\$ 44,826</u>

Nightclubs total sales for the quarter declined by 15.3% compared to a year ago because of COVID-19-related closures during the second half of March 2020. Same-store sales decrease of 14.8% included two clubs in Chicago and Pittsburgh (acquired in November 2018) for the first time. Nightclubs total sales for the first ten weeks of the quarter increased by 5.0% compared to the comparable year-ago period. Adjusted ten-week same-store sales increased by 5.6%. Sales during the first ten weeks of the current quarter benefited from a strong sports lineup in January and February, including the professional football championship in South Florida, and the professional basketball mid-season event in Chicago, as well as improved weather in January compared to the polar vortex a year ago.

Bombshells total sales for the quarter increased by 17.0% compared to a year ago, and same-store sales decreased by 13.8%. Sales reflected the success of new units, continued same-store rebound for most of the quarter, and then the COVID-19 related closures. Same-store sales included a Bombshells in the Houston suburb Pearland (opened in April 2018) for the first time. The four new Bombshells, all in the Houston area, were I-10 (opened December 2018), Tomball (March 2019), Katy (October 2019), and US 59 (January 30, 2020). Bombshells total sales for the first ten weeks of the quarter increased 45.4% compared to the corresponding year-ago period. Adjusted ten-week same-store sales increased 3.6%.

Operating Expenses

Total operating expenses, as a percent of revenues, increased to 106.1% from 75.1% from year-ago, with a \$9.2 million increase, or 27.5%. Significant contributors to the changes in operating expenses are explained below.

Cost of goods sold decreased by \$410,000, or 6.6%, mainly due to COVID-19-related closures. As a percent of total revenues, cost of goods sold increased to 14.3% from 13.8% mainly due to perishable inventory spoilage.

Salaries and wages increased by \$314,000, or 2.6%. As a percent of total revenues, salaries and wages were 30.2% from 26.6% mainly due to fixed salaries paid even during COVID-19-related closures.

Selling, general and administrative expenses increased by \$109,000, or 0.8%, primarily caused by fixed costs.

Our adoption of ASC 842 as of October 1, 2019 did not have an impact in our results of operations and cash flows for the three months ended March 31, 2020. See Note 2 to our unaudited condensed consolidated financial statements.

Depreciation and amortization increased by \$57,000, or 2.6% due to higher unit count from new units.

Other charges/gains, net of \$8.2 million in net charge during the current quarter compared to a net gain of \$981,000 in the prior-year quarter. The current quarter net charge was mainly from approximately \$8.2 million in impairment of goodwill (\$6.5 million), SOB licenses (\$1.4 million), and property and equipment (\$302,000). Last year's quarter benefited from the sale of two real estate properties.

Income from Operations

For the three months ended March 31, 2020 and 2019, our operating margin was (6.1%) and 24.9%, respectively. The main driver for the decrease in operating margin is the COVID-19-related closures.

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

	For the Three Months Ended March 31,	
	2020	2019
Nightclubs	\$ 2,314	\$ 15,078
Bombshells	690	738
Other	(178)	(176)
General corporate	(5,301)	(4,474)
	<u>\$ (2,475)</u>	<u>\$ 11,166</u>

Operating margin for the Nightclubs segment was 7.4% and 40.7% for the three months ended March 31, 2020 and 2019, respectively, while operating margin for Bombshells was 7.8% and 9.8%, respectively. The decrease in both Nightclubs and Bombshells operating margin was mainly due to COVID-19-related closures plus the impairment charges. Excluding impairment charges, amortization of intangibles and gain on disposal of assets, Nightclubs would have had non-GAAP operating margin of 32.9% and 38.2% for the three months ended March 31, 2020 and 2019, respectively. Excluding impairment charges and amortization of intangibles, Bombshells would have had non-GAAP operating margin of 10.7% and 9.8% for the three months ended March 31, 2020 and 2019.

Non-Operating Items

Interest expense decreased by \$186,000, or 7.0%.

Our total occupancy costs, defined as the sum of lease expense and interest expense, were 8.6% and 8.0% of revenue during the three months ended March 31, 2020 and 2019, respectively. The higher occupancy costs in the current quarter were fixed interest and lease expenses in relation to declining revenues.

Income Taxes

Income taxes were a \$1.4 million benefit and a \$1.9 million expense during the three months ended March 31, 2020 and 2019, respectively, with an effective income tax rate of 28.9% benefit and 22.3% expense, respectively. Our effective tax rate for both years is affected by state taxes, permanent differences, and tax credits, including the FICA tip credit. Our revised estimate of our annual effective income tax rate for fiscal 2020 caused the cumulative effect to be recognized in the current quarter.

Six Months Ended March 31, 2020 Compared to Six Months Ended March 31, 2019

The following table summarizes our results of operations for the six months ended March 31, 2020 and 2019 (dollars in thousands):

	For the Six Months Ended				Increase (Decrease)	
	March 31, 2020		March 31, 2019		Amount	%
	Amount	% of Revenues	Amount	% of Revenues		
Revenues						
Sales of alcoholic beverages	\$ 37,662	42.4%	\$ 36,796	41.4%	\$ 866	2.4%
Sales of food and merchandise	13,926	15.7%	12,129	13.7%	1,797	14.8%
Service revenues	31,541	35.5%	34,310	38.6%	(2,769)	(8.1)%
Other	5,691	6.4%	5,614	6.3%	77	1.4%
Total revenues	<u>88,820</u>	100.0%	<u>88,849</u>	100.0%	<u>(29)</u>	<u>(0.0)%</u>
Operating expenses						
Cost of goods sold						
Alcoholic beverages sold	7,581	20.1%	7,526	20.5%	55	0.7%
Food and merchandise sold	4,792	34.4%	4,292	35.4%	500	11.6%
Service and other	185	0.5%	186	0.5%	(1)	(0.5)%
Total cost of goods sold (exclusive of items shown separately below)	12,558	14.1%	12,004	13.5%	554	4.6%
Salaries and wages	25,445	28.6%	24,004	27.0%	1,441	6.0%
Selling, general and administrative	30,981	34.9%	28,368	31.9%	2,613	9.2%
Depreciation and amortization	4,461	5.0%	4,253	4.8%	208	4.9%
Other charges (gains), net	8,164	9.2%	(2,078)	(2.3%)	10,242	492.9%
Total operating expenses	<u>81,609</u>	91.9%	<u>66,551</u>	74.9%	<u>15,058</u>	<u>22.6%</u>
Income from operations	7,211	8.1%	22,298	25.1%	(15,087)	(67.7)%
Other income (expenses)						
Interest expense	(4,944)	(5.6%)	(5,166)	(5.8%)	(222)	(4.3)%
Interest income	183	0.2%	126	0.1%	57	45.2%
Unrealized loss on equity securities	(134)	(0.2%)	(370)	(0.4%)	236	63.8%
Income before income taxes	2,316	2.6%	16,888	19.0%	(14,572)	(86.3)%
Income tax expense	175	0.2%	3,741	4.2%	(3,566)	(95.3)%
Net income	<u>\$ 2,141</u>	2.4%	<u>\$ 13,147</u>	14.8%	<u>\$ (11,006)</u>	<u>(83.7)%</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 were flat at \$88.8 million for both current and prior year. The sales decline caused by the COVID-19 pandemic decimated the sales gains we accumulated during the first five months of our fiscal year. Consolidated same-store sales during the quarter decreased by 7.3% (Nightclubs decreased by 8.4% while Bombshells increased by 0.7%). Prior to the stay-at-home and social distancing guidelines imposed by the federal, state and local governments, during the first ten weeks of the quarter, consolidated same-store sales was up by 5.3% (Nightclubs increased by 5.6% while Bombshells increased by 3.6%).

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

	For the Six Months Ended March 31,	
	2020	2019
Nightclubs	\$ 69,226	\$ 74,775
Bombshells	19,153	13,540
Other	441	534
	<u>\$ 88,820</u>	<u>\$ 88,849</u>

Nightclubs total sales for the six months ended March 31, 2020 declined by 7.4% compared to a year ago because of COVID-19-related closures during the second half of March 2020. Same-store sales decrease of 8.4% included two clubs in Chicago and Pittsburgh (acquired in November 2018) for the first time in the current year second quarter. Nightclubs total sales for the first ten weeks of the quarter increased by 5.0% compared to the comparable year-ago period. Adjusted ten-week same-store sales increased by 5.6%. Sales during the first ten weeks of the current quarter benefited from a strong sports lineup in January and February, including the professional football championship in South Florida, and the professional basketball mid-season event in Chicago, as well as improved weather in January compared to the polar vortex a year ago.

Bombshells total sales for the six months ended March 31, 2020 increased by 41.5% compared to a year ago, and same-store sales increased by 0.7%. Sales reflected the success of new units, continued same-store rebound for most of the six months, and then the COVID-19 related closures. Same-store sales included a Bombshells in the Houston suburb Pearland (opened in April 2018) for the first time in the current year second quarter. The four new Bombshells, all in the Houston area, were I-10 (opened December 2018), Tomball (March 2019), Katy (October 2019), and US 59 (January 30, 2020). Bombshells total sales for the first ten weeks of the quarter increased 45.4% compared to the corresponding year-ago period. Adjusted ten-week same-store sales increased 3.6%.

Operating Expenses

Total operating expenses, as a percent of revenues, increased to 91.5% from 74.9% from year-ago, with a \$15.1 million increase, or 22.6%. Significant contributors to the changes in operating expenses are explained below.

Cost of goods sold increased by \$554,000, or 4.6%, mainly due to COVID-19-related closures. As a percent of total revenues, cost of goods sold increased to 14.1% from 13.5% mainly due to perishable inventory spoilage.

Salaries and wages increased by \$1.4 million, or 6.0%. As a percent of total revenues, salaries and wages were 28.6% from 27.0% mainly due to fixed salaries paid even during COVID-19-related closures.

Selling, general and administrative expenses increased by \$2.6 million, or 9.2%, primarily caused by fixed costs. \$2.5 million of the increase was from the first quarter, pre-COVID-19, mainly from increases in accounting and professional fees, taxes and permits, advertising and marketing, utilities, and repairs and maintenance.

Our adoption of ASC 842 as of October 1, 2019 did not have an impact in our results of operations and cash flows for the six months ended March 31, 2020. See Note 2 to our unaudited condensed consolidated financial statements.

Depreciation and amortization increased by \$208,000, or 4.9% due to higher unit count from new units.

Other charges/gains, net of \$8.2 million in net charge in the current year compared to a net gain of \$2.1 million in the prior year. The current year net charge was mainly from approximately \$8.2 million in impairment of goodwill (\$6.5 million), SOB licenses (\$1.4 million), and property and equipment (\$302,000). Last year benefited from the sale of two real estate properties, two assets held for sale and a club in Philadelphia.

Income from Operations

For the six months ended March 31, 2020 and 2019, our operating margin was 8.1% and 25.1%, respectively. The main driver for the decrease in operating margin is the COVID-19-related closures.

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

	For the Six Months Ended March 31,	
	2020	2019
Nightclubs	\$ 16,090	\$ 30,465
Bombshells	2,263	857
Other	(385)	(295)
General corporate	(10,757)	(8,729)
	<u>\$ 7,211</u>	<u>\$ 22,298</u>

Operating margin for the Nightclubs segment was 23.2% and 40.7% for the six months ended March 31, 2020 and 2019, respectively, while operating margin for Bombshells was 11.8% and 6.3%, respectively. The decrease in Nightclubs operating margin was mainly due to COVID-19-related closures plus the impairment charges. The increase in Bombshells operating margin was caused by early gains from reduction in pre-opening expenses partially offset by COVID-19-related closures plus the impairment charges. Excluding impairment charges, amortization of intangibles, gain on disposal of assets, gain on insurance and settlement of lawsuits, Nightclubs would have had non-GAAP operating margin of 34.9% and 38.0% for the six months ended March 31, 2020 and 2019, respectively. Excluding impairment charges, amortization of intangibles, settlement of lawsuits and loss on sale of assets, Bombshells would have had non-GAAP operating margin of 13.1% and 6.4% for the six months ended March 31, 2020 and 2019.

Non-Operating Items

Interest expense decreased by \$222,000, or 4.3%.

Our total occupancy costs, defined as the sum of lease expense and interest expense, were 7.9% and 8.0% of revenue during the six months ended March 31, 2020 and 2019, respectively.

Income Taxes

Income taxes expense was \$175,000 and \$3.7 million during the six months ended March 31, 2020 and 2019, respectively, with an effective income tax rate of 7.6% and 22.2%, respectively. Our effective tax rate for both years is affected by state taxes, permanent differences, and tax credits, including the FICA tip credit. We revised our estimate of our annual effective income tax rate for fiscal 2020 due to the forecasted financial impact of the COVID-19 pandemic.

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) gains or losses on sale of businesses and assets, (c) gains or losses on insurance, (d) settlement of lawsuits, and (e) impairment of assets. 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) gains or losses on sale of businesses and assets, (c) gains or losses on insurance, (d) unrealized gains or losses on equity securities, (e) settlement of lawsuits, (f) impairment of assets, and (g) 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 7.6% and 22.1% effective tax rate of the pre-tax non-GAAP income before taxes for the six months ended March 31, 2020 and 2019, 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 and amortization, (b) income tax expense (benefit), (c) net interest expense, (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) impairment of assets. 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, 2020 and 2019 (in thousands, except per share amounts and percentages):

	For the Three Months Ended March 31,		For the Six Months Ended March 31,	
	2020	2019	2020	2019
Reconciliation of GAAP net income (loss) to Adjusted EBITDA				
Net income (loss) attributable to RCIHH common stockholders	\$ (3,452)	\$ 6,735	\$ 2,182	\$ 13,079
Income tax expense (benefit)	(1,418)	1,930	175	3,741
Interest expense, net	2,374	2,570	4,761	5,040
Settlement of lawsuits	-	84	24	144
Impairment of assets	8,210	-	8,210	-
Gain on sale of businesses and assets	(7)	(1,065)	(37)	(2,222)
Unrealized loss (gain) on equity securities	62	(77)	134	370
Gain on insurance	(13)	-	(33)	-
Depreciation and amortization	2,257	2,200	4,461	4,253
Adjusted EBITDA	<u>\$ 8,013</u>	<u>\$ 12,377</u>	<u>\$ 19,877</u>	<u>\$ 24,405</u>
Reconciliation of GAAP net income (loss) to non-GAAP net income				
Net income (loss) attributable to RCIHH common stockholders	\$ (3,452)	\$ 6,735	\$ 2,182	\$ 13,079
Amortization of intangibles	157	153	313	309
Settlement of lawsuits	-	84	24	144
Impairment of assets	8,210	-	8,210	-
Gain on sale of businesses and assets	(7)	(1,065)	(37)	(2,222)
Unrealized loss (gain) on equity securities	62	(77)	134	370
Gain on insurance	(13)	-	(33)	-
Income tax effect of adjustments above	(633)	223	(659)	333
Non-GAAP net income	<u>\$ 4,324</u>	<u>\$ 6,053</u>	<u>\$ 10,134</u>	<u>\$ 12,013</u>
Reconciliation of GAAP diluted earnings (loss) per share to non-GAAP diluted earnings per share				
Diluted shares	9,225	9,679	9,274	9,696
GAAP diluted earnings (loss) per share	\$ (0.37)	\$ 0.70	\$ 0.24	\$ 1.35
Amortization of intangibles	0.02	0.02	0.03	0.03
Settlement of lawsuits	-	0.01	0.00	0.01
Impairment of assets	0.89	-	0.89	-
Gain on sale of businesses and assets	(0.00)	(0.11)	(0.00)	(0.23)
Unrealized loss (gain) on equity securities	0.01	(0.01)	0.01	0.04
Gain on insurance	(0.00)	-	(0.00)	-
Income tax effect of adjustments above	(0.07)	0.02	(0.07)	0.03
Non-GAAP diluted earnings per share	<u>\$ 0.47</u>	<u>\$ 0.63</u>	<u>\$ 1.09</u>	<u>\$ 1.24</u>
Reconciliation of GAAP operating income (loss) to non-GAAP operating income				
Income (loss) from operations	\$ (2,475)	\$ 11,166	\$ 7,211	\$ 22,298
Amortization of intangibles	157	153	313	309
Settlement of lawsuits	-	84	24	144
Impairment of assets	8,210	-	8,210	-
Gain on insurance	(13)	-	(33)	-
Gain on sale of businesses and assets	(7)	(1,065)	(37)	(2,222)
Non-GAAP operating income	<u>\$ 5,872</u>	<u>\$ 10,338</u>	<u>\$ 15,688</u>	<u>\$ 20,529</u>
Reconciliation of GAAP operating margin to non-GAAP operating margin				
GAAP operating margin	(6.1%)	24.9%	8.1%	25.1%
Amortization of intangibles	0.4%	0.3%	0.4%	0.3%
Settlement of lawsuits	-	0.2%	0.0%	0.2%
Impairment of assets	20.3%	-	9.2%	-
Gain on insurance	(0.0%)	-	(0.0%)	-
Gain on sale of businesses and assets	(0.0%)	(2.4%)	(0.0%)	(2.5%)
Non-GAAP operating margin	<u>14.5%</u>	<u>23.1%</u>	<u>17.7%</u>	<u>23.1%</u>

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

The adjustments to reconcile net income attributable to RCIHH 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, 2020, our cash and cash equivalents were approximately \$9.8 million compared to \$14.1 million at September 30, 2019. Because of the large volume of cash we handle, we have very stringent cash controls. As of March 31, 2020, we had negative working capital of \$4.6 million compared to a negative working capital of \$2.3 million as of September 30, 2019, excluding net assets held for sale of \$3.6 million and \$2.9 million as of March 31, 2020 and September 30, 2019, respectively. Although we believe that our ability to generate cash from operating activities is one of our fundamental financial strengths, the closure of our clubs and restaurants caused by the COVID-19 pandemic has presented operational challenges. Our strategy is to open locations in accordance with local and state guidelines and it is too early to know when and if they will generate positive cash flows for us. Depending on the timing and number of locations we get open, and their ability to generate positive cash flow, we may need to borrow funds to meet our obligations or consider selling certain assets. Based upon the small sampling of early openings in Texas, revenues seem favorable. We are hopeful that we can become profitable within a relatively short period of time after a majority of our locations have reopened, assuming these results can be sustained and the other locations, once opened, follow these early results. But if the business interruptions caused by COVID-19 last longer than we expect, we may need to seek other sources of liquidity. The COVID-19 pandemic is adversely affecting the availability of liquidity generally in the credit markets, and there can be no guarantee that additional liquidity will be readily available or available on favorable terms, especially the longer the COVID-19 pandemic lasts.

We now currently forecast our cash flows to fall significantly lower than the levels that we initially targeted. To augment an expected decline in operating cash flows caused by the COVID-19 pandemic, we instituted the following measures:

- Arranged for deferment of principal and interest payment on certain of our debts;
- Furloughed employees working at our clubs and restaurants, except for a limited number of managers;
- Pay cut for all remaining salaried and hourly employees and deferral of board of director compensation Deferred or modified certain fixed monthly expenses such as insurance, rent, and taxes, among others;
- Deferred or modified certain fixed monthly expenses such as insurance, rent, and taxes, among others;
- Canceled certain non-essential expenses such as advertising, cable, pest control, point-of-sale system support, and investor relations coverage, among others.

On May 8, 2020, the Company received approval and funding under the Paycheck Protection Program of the CARES Act for its restaurants, shared service entity and lounge. Ten of our restaurant subsidiaries received amounts ranging from \$271,000 to \$579,000 for an aggregate amount of \$4.2 million; our shared-services subsidiary received \$1.1 million; and one of our lounges received \$124,000. None of our adult nightclub and other non-core business subsidiaries received funding under the PPP.

As of the release of this report, we do not know the extent and duration of the impact of COVID-19 on our businesses due to the uncertainty about the spread of the virus. Lower sales, as caused by social distancing guidelines, could lead to adverse financial results. However, we will continually monitor and evaluate our cash flow situation and will determine any further measures to be instituted.

Also as of the release of this report, we have ten locations in Texas that have partially reopened with 25% occupancy requirement.

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, but with the significant global impact of the COVID-19 pandemic, there can be no assurance that any of these financing options would be presently available on favorable terms, if at all. 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,	
	2020	2019
Operating activities	\$ 11,981	\$ 20,971
Investing activities	(3,870)	(24,888)
Financing activities	(12,383)	(5,554)
Net decrease in cash and cash equivalents	\$ (4,272)	\$ (9,471)

Cash Flows from Operating Activities

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

	For the Six Months Ended March 31,	
	2020	2019
Net income	\$ 2,141	\$ 13,147
Depreciation and amortization	4,461	4,253
Deferred tax expense (benefit)	(1,155)	1,131
Impairment of assets	8,210	-
Net change in operating assets and liabilities	(2,695)	3,876
Other	1,019	(1,436)
Net cash provided by operating activities	\$ 11,981	\$ 20,971

Net cash provided by operating activities decreased from year-to-year due primarily to the impact of the COVID-19 pandemic and higher income taxes paid partially offset by lower 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,	
	2020	2019
Payments for property and equipment and intangible assets	\$ (5,323)	\$ (13,902)
Acquisition of businesses, net of cash acquired	-	(13,500)
Proceeds from sale of businesses and assets	105	2,866
Proceeds from insurance	945	-
Proceeds from notes receivable	403	68
Issuance of note receivable	-	(420)
Net cash used in investing activities	\$ (3,870)	\$ (24,888)

Following is a breakdown of our payments for property and equipment and intangible assets for the six months ended March 31, 2020 and 2019 (in thousands):

	For the Six Months Ended March 31,	
	2020	2019
New facilities, equipment and software	\$ 3,212	\$ 12,785
Maintenance capital expenditures	2,111	1,117
Total capital expenditures	\$ 5,323	\$ 13,902

The capital expenditures during the six months ended March 31, 2020 were composed primarily of construction and development costs for two new Bombshells locations and the rehabilitation of a club that was damaged by fire, while the capital expenditures during the six months ended March 31, 2019 were composed primarily of construction and development costs for four new Bombshells locations. Variances in capital expenditures are primarily due to the number and timing of new, remodeled, or reconcepted locations under construction.

Prior year acquisitions of \$13.5 million 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,	
	2020	2019
Proceeds from long-term debt	\$ 880	\$ 10,296
Payments on long-term debt	(4,097)	(13,287)
Purchase of treasury stock	(8,488)	(1,961)
Payment of dividends	(647)	(582)
Payment of loan origination costs	-	(20)
Distribution to noncontrolling interests	(31)	-
Net cash used in financing activities	\$ (12,383)	\$ (5,554)

We purchased 465,390 shares of our common stock at an average price of \$18.24 during the six months ended March 31, 2020, while we purchased 84,811 shares of our common stock at an average price of \$23.13 during the same period last year. We paid quarterly dividends of \$0.03 per share during each of the current- and prior-year quarters, except in the second quarter of 2020 where we paid \$0.04 per share.

Management also uses certain non-GAAP cash flow measures such as free cash flow. We calculate free cash flow as 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,	
	2020	2019
Net cash provided by operating activities	\$ 11,981	\$ 20,971
Less: Maintenance capital expenditures	2,111	1,117
Free cash flow	\$ 9,870	\$ 19,854

Our free cash flow for the current year decreased by 50.3% compared to the comparable prior-year period primarily due to the impact of the COVID-19 pandemic and capital expenditures on remodeling of an older Bombshells unit and on upgrades in our Miami clubs in preparation for the pro football championship.

Other than the potentially prolonged effect of the COVID-19 pandemic and the notes payable financing described above, we are not aware of any event or trend that would potentially significantly affect liquidity. 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>2020</u>	<u>Increase (Decrease)</u>	<u>2019</u>	<u>Increase (Decrease)</u>	<u>2018</u>
Sales of alcoholic beverages	\$ 37,662	2.4%	\$ 36,796	4.6%	\$ 35,177
Sales of food and merchandise	13,926	14.8%	12,129	13.0%	10,731
Service revenues	31,541	(8.1%)	34,310	7.1%	32,022
Other	5,691	1.4%	5,614	24.5%	4,508
Total revenues	88,820	(0.0%)	88,849	7.8%	82,438
Net cash provided by operating activities	\$ 11,981	(42.9%)	\$ 20,971	49.0%	\$ 14,077
Adjusted EBITDA*	\$ 19,877	(18.6%)	\$ 24,405	3.8%	\$ 23,520
Free cash flow*	\$ 9,870	(50.3%)	\$ 19,854	54.9%	\$ 12,815
Long-term debt (end of period)**	\$ 140,440	(6.3%)	\$ 149,818	17.8%	\$ 127,213

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

** Balance as of March 31, 2020 includes liabilities associated with held-for-sale assets amounting to \$1.2 million.

Share Repurchase

We purchased 465,390 shares of our common stock at an average price of \$18.24 during the six months ended March 31, 2020, while we purchased 84,811 shares of our common stock at an average price of \$23.13 during the same period last year. In February 2020, the Company's Board of Directors authorized an additional \$10.0 million to repurchase the Company's common stock. As of March 31, 2020, we have \$11.8 million remaining to purchase additional shares under our share repurchase program.

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, management believes that we are able to make better investment decisions.

Based on our current capital allocation strategy:

- We consider buying back our own stock if the after-tax yield on free cash flow is above 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 ten of the existing Bombshells as of March 31, 2020 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 one Bombshells unit during the quarter ended December 31, 2019, and opened another unit during the quarter ended March 31, 2020.

On November 5, 2019, we announced that our subsidiaries have signed definitive agreements to acquire the assets and related real estate of a well-established, top gentlemen's club located in the Northeast Corridor for \$15.0 million. The agreements terminated prior to closing. We provided the sellers notice of the termination in April 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, 2020, 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, 2019.

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, 2020, 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, 2020. This determination is based on the previously reported material weakness management previously identified in our internal control over financial reporting, as described below. We are in the process of remediating the material weaknesses in our internal control, as described below. We believe the completion of these processes should remedy our disclosure controls and procedures. We will continue to monitor these issues.

Previously Reported Material Weakness in Internal Control Over Financial Reporting

In our Annual Report for the year ended September 30, 2019, filed with the SEC on February 13, 2020, management concluded that our internal control over financial reporting was not effective as of September 30, 2019. In the evaluation, management identified a material weakness in internal control related to ineffective financial statement close and reporting controls in the areas of management review of financial statement information, independent review of journal entries, disclosure of related party transactions, and accounting for loss contingencies.

Remediation Efforts to Address Material Weakness

Management is committed to the remediation of the material weakness described above, as well as the continued improvement of the Company's internal control over financial reporting. Management has been implementing, and continues to implement, measures designed to ensure that control deficiencies contributing to the material weakness are remediated, such that these controls are designed, implemented, and operating effectively.

To address the material weakness, management has completed, or is in the process of:

- developing policies and procedures to enhance the precision of management review of financial statement information;
- implementing policies and procedures to enhance independent review of journal entries;
- developing and implementing procedures to ensure the completeness of related party disclosures; and
- developing and implementing procedures related to the identification and accounting for loss contingencies.

We believe that these actions will remediate the material weakness. The material weakness will not be considered remediated, however, until the applicable controls operate for a sufficient period of time and management has concluded, through testing, that these controls are 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, 2020 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, 2019, 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 COVID-19 pandemic, as disclosed below. 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.

The novel coronavirus (COVID-19) pandemic has disrupted and is expected to continue to disrupt our business, which has and could continue to materially affect our operations, financial condition and results of operations for an extended period of time.

The COVID-19 pandemic has had an adverse effect that is material on our business. The COVID-19 pandemic, federal, state and local government responses to COVID-19, our customers’ responses to the pandemic, and our Company’s responses to the pandemic have all disrupted and will continue to disrupt our business. In the United States, as well as globally, individuals are being encouraged to practice social distancing, restricted from gathering in groups and in some areas, placed on complete restriction from non-essential movements outside of their homes. In response to the COVID-19 pandemic and these changing conditions, as of March 18, 2020, we temporarily closed all of our clubs and restaurants. We furloughed club and restaurant employees, except for a limited number of unit managers, and implemented cost savings measures throughout our operations. The COVID-19 pandemic’s impact on the economy in general could also adversely affect our customers’ financial condition, resulting in reduced spending at our clubs and restaurants. The COVID-19 pandemic and these responses have affected and will continue to adversely affect our customer traffic, sales and operating costs and we cannot predict how long the pandemic will last or what other government responses may occur.

If the business interruptions caused by COVID-19 last longer than we expect, we may need to seek other sources of liquidity. The COVID-19 pandemic is adversely affecting the availability of liquidity generally in the credit markets, and there can be no guarantee that additional liquidity will be readily available or available on favorable terms, especially the longer the COVID-19 pandemic lasts.

Our club and restaurant operations could be further disrupted if any of our employees are diagnosed with COVID-19 and the circumstances require quarantine of some or all of a club or restaurant’s employees and disinfection of the facilities. If a significant percentage of our workforce is unable to work, whether because of illness, quarantine, limitations on travel or other government restrictions in connection with COVID-19, our operations may be negatively impacted, potentially materially adversely affecting our liquidity, financial condition or results of operations. Those employees might seek and find other employment during our business interruption, which could materially adversely affect our ability to properly staff and reopen our clubs and restaurants with experienced team members when permitted to do so by governments.

Our suppliers could be adversely impacted by the COVID-19 pandemic. If our suppliers’ employees are unable to work, whether because of illness, quarantine, limitations on travel or other government restrictions in connection with COVID-19, we could face shortages of food items or other supplies at our restaurants and our operations and sales could be adversely impacted by such supply interruptions.

The equity markets in the United States have been extremely volatile due to the COVID-19 pandemic and the Company’s stock price has fluctuated significantly.

We cannot predict how soon we will be able to reopen all our clubs and restaurants, as our ability to reopen our locations will depend in part on the actions of a number of governmental bodies over which we have no control. Moreover, once restrictions are lifted, it is unclear how quickly customers will return to our clubs and restaurants, which may be a function of continued concerns over safety and/or depressed consumer sentiment due to adverse economic conditions, including job losses. Considering the significant uncertainty as to when we can reopen some or all of our locations and the uncertain customer demand environment, in addition to the actions described above, we have taken action to reduce our cash expenditures, which may impact our future growth, refer to Item 2 - Management’s Discussion and Analysis of Financial Condition and Results of Operations discussions on Liquidity for further information.

If we are unable to maintain compliance with certain of our debt covenants, we may be unable to make additional borrowings and be declared in default where our debt will be made immediately due and payable. In addition, global economic conditions may make it more difficult to access new credit facilities.

Our liquidity position is, in part, dependent upon our ability to borrow funds from financial institutions and/or private individuals. Certain of our debts have financial covenants that require us to maintain certain operating income to debt service ratios. As of March 31, 2020, we were in compliance with all covenants. However, as a result of the COVID-19 outbreak, our total revenues have decreased significantly and we have implemented certain operational changes in order to address the evolving challenges presented by the global pandemic on our operations. Due to the impact of COVID-19, our financial performance in future fiscal quarters will be negatively impacted. A failure to comply with the financial covenants under our credit facility would give rise to an event of default under the terms of certain of our debts, allowing the lenders to accelerate repayment of any outstanding debt.

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. In January 2019, the Board of Directors increased the repurchase authorization by an additional \$10.0 million. During the quarter ended December 31, 2019, we purchased 332,671 shares of our common stock in the open market at prices ranging from \$18.30 to \$20.80 per share. In February 2020, the Board of Directors increased the repurchase authorization by an additional \$10.0 million. As of May 8, 2020, we have \$11.8 million remaining to purchase additional shares.

Following is a summary of our purchases during the quarter ended March 31, 2020:

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, 2020	-		-	\$ 3,798,030
February 1-29, 2020	-		-	\$ 13,798,030
March 1-31, 2020	132,719	\$ 15.42	132,719	\$ 11,751,514
Total	<u>132,719</u>	\$ 15.42	<u>132,719</u>	

(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.

Exhibit No.	Description
31.1	<u>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.</u>
31.2	<u>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.</u>
32	<u>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.</u>
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.

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: May 11, 2020

By: /s/ Eric S. Langan

Eric S. Langan
Chief Executive Officer and President

Date: May 11, 2020

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: May 11, 2020

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: May 11, 2020

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, 2020 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
May 11, 2020

/s/ Phillip K. Marshall

Phillip K. Marshall
Chief Financial Officer
May 11, 2020

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.
