
**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 June 30, 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:

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

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

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

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

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

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

As of August 7, 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)**

	June 30, 2020 (unaudited)	September 30, 2019
ASSETS		
Current assets		
Cash and cash equivalents	\$ 14,795	\$ 14,097
Accounts receivable, net	5,529	6,289
Current portion of notes receivable	219	954
Inventories	2,627	2,598
Prepaid insurance	1,415	5,446
Other current assets	1,752	2,521
Assets held for sale	2,013	2,866
Total current assets	28,350	34,771
Property and equipment, net	181,960	183,956
Operating lease right-of-use assets, net	25,962	-
Notes receivable, net of current portion	2,896	4,211
Goodwill	47,109	53,630
Intangibles, net	73,224	75,951
Other assets	873	1,118
Total assets	\$ 360,374	\$ 353,637
LIABILITIES AND EQUITY		
Current liabilities		
Accounts payable	\$ 3,955	\$ 3,810
Accrued liabilities	10,286	14,644
Current portion of long-term debt, net	17,249	15,754
Current portion of operating lease liabilities	1,586	-
Total current liabilities	33,076	34,208
Deferred tax liability, net	20,141	21,658
Long-term debt, net of current portion and debt discount and issuance costs	125,487	127,774
Operating lease liabilities, net of current portion	25,863	-
Other long-term liabilities	372	1,696
Total liabilities	204,939	185,336
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 June 30, 2020 and September 30, 2019, respectively	91	96
Additional paid-in capital	52,829	61,312
Retained earnings	102,837	107,049
Total RCIHH stockholders' equity	155,757	168,457
Noncontrolling interests	(322)	(156)
Total equity	155,435	168,301
Total liabilities and equity	\$ 360,374	\$ 353,637

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 June 30,		For the Nine Months Ended June 30,	
	2020	2019	2020	2019
Revenues				
Sales of alcoholic beverages	\$ 7,623	\$ 19,570	\$ 45,285	\$ 56,366
Sales of food and merchandise	3,452	7,046	17,378	19,175
Service revenues	2,907	17,299	34,448	51,609
Other	739	3,112	6,430	8,726
Total revenues	<u>14,721</u>	<u>47,027</u>	<u>103,541</u>	<u>135,876</u>
Operating expenses				
Cost of goods sold				
Alcoholic beverages sold	1,245	4,015	8,826	11,541
Food and merchandise sold	1,125	2,565	5,917	6,857
Service and other	20	121	205	307
Total cost of goods sold (exclusive of items shown separately below)	2,390	6,701	14,948	18,705
Salaries and wages	5,421	13,164	30,866	37,168
Selling, general and administrative	8,908	14,895	39,889	43,263
Depreciation and amortization	2,235	2,465	6,696	6,718
Other charges (gains), net	424	(172)	8,588	(2,250)
Total operating expenses	<u>19,378</u>	<u>37,053</u>	<u>100,987</u>	<u>103,604</u>
Income (loss) from operations	(4,657)	9,974	2,554	32,272
Other income (expenses)				
Interest expense	(2,459)	(2,543)	(7,403)	(7,709)
Interest income	80	92	263	218
Unrealized gain (loss) on equity securities	31	(38)	(103)	(408)
Income (loss) before income taxes	(7,005)	7,485	(4,689)	24,373
Income tax expense (benefit)	(1,437)	1,806	(1,262)	5,547
Net income (loss)	(5,568)	5,679	(3,427)	18,826
Net loss (income) attributable to noncontrolling interests	94	(41)	135	(109)
Net income (loss) attributable to RCIHH common stockholders	<u>\$ (5,474)</u>	<u>\$ 5,638</u>	<u>\$ (3,292)</u>	<u>\$ 18,717</u>
Earnings (loss) per share				
Basic and diluted	\$ (0.60)	\$ 0.59	\$ (0.36)	\$ 1.94
Weighted average number of common shares outstanding				
Basic and diluted	9,125	9,620	9,224	9,671
Dividends per share	\$ 0.03	\$ 0.03	\$ 0.10	\$ 0.09

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 (loss)	-	-	-	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 income (loss)	-	-	-	(3,452)	-	-	-	(41)	(3,493)
Balance at March 31, 2020	9,125	91	52,829	\$ 108,584	-	-	-	(228)	161,276
Payment of dividends	-	-	-	(273)	-	-	-	-	(273)
Net income (loss)	-	-	-	(5,474)	-	-	-	(94)	(5,568)
Balance at June 30, 2020	9,125	\$ 91	\$ 52,829	\$ 102,837	\$ -	-	\$ -	\$ (322)	\$ 155,435
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 (loss)	-	-	-	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 (loss)	-	-	-	6,735	-	-	-	8	6,743
Balance at March 31, 2019	9,634	96	62,252	101,623	-	-	-	(35)	163,936
Purchase of treasury shares	-	-	-	-	-	(17)	(403)	-	(403)
Canceled treasury shares	(17)	-	(403)	-	-	17	403	-	-
Payment of dividends	-	-	-	(285)	-	-	-	-	(285)
Payment to noncontrolling interest	-	-	-	-	-	-	-	(21)	(21)
Net income (loss)	-	-	-	5,638	-	-	-	41	5,679
Balance at June 30, 2019	9,617	\$ 96	\$ 61,849	\$ 106,976	\$ -	-	\$ -	\$ (15)	\$ 168,906

See accompanying notes to unaudited condensed consolidated financial statements.

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

	For the Nine Months Ended June 30,	
	2020	2019
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	\$ (3,427)	\$ 18,826
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	6,696	6,718
Deferred income tax expense (benefit)	(1,517)	1,237
Gain on sale of businesses and assets	(749)	(2,704)
Impairment of assets	9,192	-
Unrealized loss on equity securities	103	408
Amortization of debt discount and issuance costs	194	276
Deferred rent	-	236
Noncash lease expense	1,244	-
Loss (gain) on insurance	(33)	93
Doubtful accounts expense on notes receivable	495	-
Changes in operating assets and liabilities:		
Accounts receivable	(53)	2,305
Inventories	(29)	(87)
Prepaid insurance, other current and other assets	4,942	4,199
Accounts payable, accrued and other liabilities	(4,911)	(3,093)
Net cash provided by operating activities	<u>12,147</u>	<u>28,414</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sale of businesses and assets	2,041	5,106
Proceeds from insurance	945	-
Proceeds from notes receivable	1,555	107
Issuance of note receivable	-	(420)
Payments for property and equipment and intangible assets	(5,565)	(16,901)
Acquisition of businesses, net of cash acquired	-	(13,500)
Net cash used in investing activities	<u>(1,024)</u>	<u>(25,608)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from debt obligations	6,503	12,330
Payments on debt obligations	(7,489)	(18,634)
Purchase of treasury stock	(8,488)	(2,364)
Payment of dividends	(920)	(867)
Payment of loan origination costs	-	(20)
Distribution to noncontrolling interests	(31)	(21)
Net cash used in financing activities	<u>(10,425)</u>	<u>(9,576)</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	698	(6,770)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	14,097	17,726
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 14,795	\$ 10,956
CASH PAID DURING PERIOD FOR:		
Interest (net of amounts capitalized of \$155 and \$447, respectively)	\$ 7,303	\$ 7,769
Income taxes	<u>\$ 2,067</u>	<u>\$ 1,827</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	\$ 6	\$ -

Non-cash and other transactions:

During the nine months ended June 30, 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 nine months ended June 30, 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 nine months ended June 30, 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 nine months ended June 30, 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 nine months ended June 30, 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. Our evaluation indicates that our consolidated financial statements will not be significantly impacted upon adoption of this guidance.

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. Our evaluation indicates that fair value disclosures in our consolidated financial statements will be minimally impacted by the requirements of this ASU.

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. Our evaluation indicates that our consolidated financial statements will not be significantly impacted upon adoption of this guidance.

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 since March 2020, we have temporarily closed and reopened several 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 and continue to arrange 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 Notes 7 and 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, including refinancing several of our debt obligations.

We continue to adhere to state and local government mandates regarding the pandemic and, since March 2020, have closed and reopened several of our locations depending on changing government mandates. As of the release of this report, we have reopened many of our club and Bombshells locations with limited occupancy but some of our bigger clubs are still closed.

Valuation of Goodwill, Indefinite-Lived Intangibles and Long-Lived 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 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 as of June 30, 2020, we determined our assets are impaired in a total amount of approximately \$9.2 million comprised of \$6.5 million in goodwill, \$2.3 million in SOB licenses, \$302,000 in property and equipment, and \$104,000 in right-of-use operating lease assets.

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. Lease revenue (included in other revenues) is recognized when earned (recognized over time) and is more appropriately covered by guidance under ASC 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 June 30, 2020				Three Months Ended June 30, 2019			
	Nightclubs	Bombshells	Other	Total	Nightclubs	Bombshells	Other	Total
Sales of alcoholic beverages	\$ 1,777	\$ 5,846	\$ -	\$ 7,623	\$ 14,597	\$ 4,973	\$ -	\$ 19,570
Sales of food and merchandise	774	2,678	-	3,452	3,313	3,733	-	7,046
Service revenues	2,906	1	-	2,907	17,257	42	-	17,299
Other revenues	556	6	177	739	2,722	7	383	3,112
	<u>\$ 6,013</u>	<u>\$ 8,531</u>	<u>\$ 177</u>	<u>\$ 14,721</u>	<u>\$ 37,889</u>	<u>\$ 8,755</u>	<u>\$ 383</u>	<u>\$ 47,027</u>
Recognized at a point in time	\$ 5,781	\$ 8,531	\$ 175	\$ 14,487	\$ 37,457	\$ 8,755	\$ 369	\$ 46,581
Recognized over time	232*	-	2	234	432*	-	14	446
	<u>\$ 6,013</u>	<u>\$ 8,531</u>	<u>\$ 177</u>	<u>\$ 14,721</u>	<u>\$ 37,889</u>	<u>\$ 8,755</u>	<u>\$ 383</u>	<u>\$ 47,027</u>

	Nine Months Ended June 30, 2020				Nine Months Ended June 30, 2019			
	Nightclubs	Bombshells	Other	Total	Nightclubs	Bombshells	Other	Total
Sales of alcoholic beverages	\$ 28,321	\$ 16,964	\$ -	\$ 45,285	\$ 43,547	\$ 12,819	\$ -	\$ 56,366
Sales of food and merchandise	6,837	10,541	-	17,378	9,813	9,362	-	19,175
Service revenues	34,290	158	-	34,448	51,513	96	-	51,609
Other revenues	5,791	21	618	6,430	7,791	18	917	8,726
	<u>\$ 75,239</u>	<u>\$ 27,684</u>	<u>\$ 618</u>	<u>\$ 103,541</u>	<u>\$ 112,664</u>	<u>\$ 22,295</u>	<u>\$ 917</u>	<u>\$ 135,876</u>
Recognized at a point in time	\$ 74,192	\$ 27,684	\$ 605	\$ 102,481	\$ 111,431	\$ 22,295	\$ 874	\$ 134,600
Recognized over time	1,047*	-	13	1,060	1,233*	-	43	1,276
	<u>\$ 75,239</u>	<u>\$ 27,684</u>	<u>\$ 618</u>	<u>\$ 103,541</u>	<u>\$ 112,664</u>	<u>\$ 22,295</u>	<u>\$ 917</u>	<u>\$ 135,876</u>

*Lease revenue (included in Other Revenues) as covered by ASC 842 in the current year (and ASC 840 in the prior year). All other revenues are covered by ASC 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 June 30, 2020
Ad revenue	\$ 76	\$ 403	\$ (412)	\$ 67
Expo revenue	-	262	-	262
Other	7	18	(23)	2
	<u>\$ 83</u>	<u>\$ 683</u>	<u>\$ (435)</u>	<u>\$ 331</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):

	June 30, 2020	September 30, 2019
Insurance	\$ 425	\$ 4,937
Sales and liquor taxes	2,844	3,086
Payroll and related costs	1,972	2,892
Property taxes	1,355	1,675
Interest	1,565	508
Patron tax	679	595
Unearned revenues	331	83
Lawsuit settlement	75	115
Other	1,040	753
	<u>\$ 10,286</u>	<u>\$ 14,644</u>

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

	For the Three Months Ended June 30,		For the Nine Months Ended June 30,	
	2020	2019	2020	2019
Taxes and permits	\$ 1,187	\$ 2,258	\$ 6,101	\$ 6,809
Advertising and marketing	428	2,083	4,745	6,301
Supplies and services	681	1,493	3,605	4,414
Insurance	1,481	1,367	4,437	4,122
Accounting and professional fees	407	631	2,916	2,559
Lease	1,010	965	3,063	2,941
Charge card fees	146	1,011	2,037	2,830
Legal	841	1,479	3,109	3,310
Utilities	512	756	2,205	2,262
Security	272	757	1,869	2,222
Repairs and maintenance	353	787	1,802	2,095
Other	1,590	1,308	4,000	3,398
	<u>\$ 8,908</u>	<u>\$ 14,895</u>	<u>\$ 39,889</u>	<u>\$ 43,263</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 three months ended December 31, 2019, the Company classified as held-for-sale another real estate property with an aggregate estimated fair value of the property less cost to sell of \$1.9 million. This property was later reclassified out of held-for-sale assets and back to property and equipment during the three months ended June 30, 2020 due to a change in management's plan with the property.

During the three months ended June 30, 2020, the Company sold one held-for-sale property valued at \$853,000 for \$1.5 million.

As of June 30, 2020, the Company has a total of one real estate property held for sale with a total value of \$2.0 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.

No liabilities were associated with held-for-sale assets as of June 30, 2020 and September 30, 2019. Gains or losses on the sale of properties held for sale are included in other charges (gains), net within the unaudited condensed consolidated statements of operations.

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7. 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 on 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 debt obligations as of June 30, 2020 and September 30, 2019 is a \$500,000 note borrowed from a related party (see Note 13) and three notes totaling \$600,000 (of which \$200,000 was included in the \$1,740,000 extension in the succeeding paragraph) 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.

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.

Future maturities of long-term debt as of June 30, 2020 are as follows: \$17.5 million, \$14.6 million, \$11.6 million, \$8.4 million, \$8.5 million and \$83.5 million for the twelve months ending June 30, 2021, 2022, 2023, 2024, 2025, and thereafter, respectively. Of the maturity schedule mentioned above, \$6.5 million, \$2.4 million, \$3.7 million, \$0, \$0 and \$41.7 million, respectively, relate to scheduled balloon payments. Unamortized debt discount and issuance costs amounted to \$1.3 million and \$1.5 million as of June 30, 2020 and September 30, 2019, respectively.

Included in the balance of debt obligations as of June 30, 2020 are PPP loans amounting to \$5.4 million. If not forgiven, under the terms of the loans as provided by the CARES Act, the twelve PPP loans bear an interest rate of 1% per annum and will be payable in 18 equal monthly installments of \$305,138 starting December 6, 2020. See Notes 3 and 9.

8. Equity

During the three and nine months ended June 30, 2020, the Company purchased and retired 0 and 465,390 common shares, respectively, at a cost of approximately \$0 and \$8.5 million, respectively. The Company paid \$0.03 and \$0.10 per share cash dividends during the three and nine months ended June 30, 2020 totaling approximately \$273,000 and \$920,000, respectively.

During the three and nine months ended June 30, 2019, the Company purchased and retired 17,302 and 102,113 common shares, respectively, at a cost of approximately \$403,000 and \$2.4 million, respectively. The Company paid a \$0.03 per share cash dividend per quarter totaling approximately \$285,000 and \$867,000 for the three and nine months ended June 30, 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 August 7, 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 tax benefit was \$1.4 million and \$1.3 million during the three and nine months ended June 30, 2020, respectively, compared to income tax expense of \$1.8 million and \$5.5 million during the three and nine months ended June 30, 2019, respectively. The effective income tax rate was a benefit of 20.5% and 26.9% during the three and nine months ended June 30, 2020, respectively, compared to expense rates of 24.1% and 22.8% during the three and nine months ended June 30, 2019, respectively. Our effective tax rate for both years is affected by the estimate of pre-tax accounting income (loss) for the year, 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, 2017 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. In July 2020, we have resolved payroll tax audits with the IRS for tax years 2014 through 2017 and have accrued approximately \$149,000 in payroll taxes and penalties, which are included in accrued liabilities in our unaudited condensed consolidated balance sheet as of June 30, 2020.

The Company accounts for uncertain tax positions pursuant to ASC Topic 740, *Income Taxes*. As of June 30, 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. See Note 3.

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 unaudited condensed consolidated balance sheets, amounted to \$2.5 million and \$3.4 million as of June 30, 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 an 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 June 30, 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. As of July 23, 2020, briefing on the motion to dismiss is complete, and we are currently waiting for the court to rule on the motion. 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 June 30, 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.

Due to several COVID-19 regulations and restrictions imposed on some of our businesses by local municipalities and/or States, certain of our subsidiaries are plaintiffs to lawsuits that have been filed on behalf of the affected entities to have the restrictions eased or removed entirely. The lawsuits may increase or decrease based on the spread of the disease and new or additional restrictions placed on our businesses.

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 nine months ended June 30, 2020 total approximately \$50,000 and \$74,000, respectively, while for the three and nine months ended June 30, 2019 total \$0 and \$144,000, respectively. As of June 30, 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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(Unaudited)

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 June 30,		For the Nine Months Ended June 30,	
	2020	2019	2020	2019
Revenues				
Nightclubs	\$ 6,013	\$ 37,889	\$ 75,239	\$ 112,664
Bombshells	8,531	8,755	27,684	22,295
Other	177	383	618	917
	<u>\$ 14,721</u>	<u>\$ 47,027</u>	<u>\$ 103,541</u>	<u>\$ 135,876</u>
Income (loss) from operations				
Nightclubs	\$ (3,088)	\$ 14,034	\$ 13,002	\$ 44,499
Bombshells	1,903	686	4,166	1,543
Other	(95)	(111)	(480)	(406)
General corporate	(3,377)	(4,635)	(14,134)	(13,364)
	<u>\$ (4,657)</u>	<u>\$ 9,974</u>	<u>\$ 2,554</u>	<u>\$ 32,272</u>
Depreciation and amortization				
Nightclubs	\$ 1,470	\$ 1,737	\$ 4,426	\$ 4,711
Bombshells	455	370	1,328	1,001
Other	103	102	311	312
General corporate	207	256	631	694
	<u>\$ 2,235</u>	<u>\$ 2,465</u>	<u>\$ 6,696</u>	<u>\$ 6,718</u>
Capital expenditures				
Nightclubs	\$ 106	\$ 1,935	\$ 2,964	\$ 3,029
Bombshells	136	900	2,473	10,697
Other	-	2	-	20
General corporate	-	162	128	3,155
	<u>\$ 242</u>	<u>\$ 2,999</u>	<u>\$ 5,565</u>	<u>\$ 16,901</u>
		<u>June 30, 2020</u>	<u>September 30, 2019</u>	
Total assets				
Nightclubs	\$	277,707	\$	274,071
Bombshells		51,907		44,144
Other		1,516		1,773
General corporate		29,244		33,649
		<u>\$ 360,374</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 June 30, 2020 and September 30, 2019 is \$84.0 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 is owned by a brother of Eric Langan (as was Sherwood Forest). Amounts billed to us for goods and services provided by Nottingham Creations and Sherwood Forest were \$0 and \$72,809 during the three and nine months ended June 30, 2020, respectively, and \$12,990 and \$120,805 during the three and nine months ended June 30, 2019, respectively. As of June 30, 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 \$0 and \$18,758 for the three and nine months ended June 30, 2020, respectively, and \$0 and \$435,800 for the three and nine months ended June 30, 2019, respectively. Amounts billed directly to the Company were \$11,363 and \$37,605 for the three and nine months ended June 30, 2020, respectively, and \$0 and \$206 for the three and nine months ended June 30, 2019, respectively. As of June 30, 2020 and September 30, 2019, the Company owed TW Mechanical \$4,439 and \$0, respectively, in unpaid direct billings.

RCI HOSPITALITY HOLDINGS, INC.
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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 nine months ended June 30, 2020, respectively, and \$19,500 and \$58,500 for the three and nine months ended June 30, 2019, respectively. This lease terminated on December 31, 2019.

Undiscounted future minimum annual lease obligations as of September 30, 2019 under ASC 840 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 \$965,000 and \$2.9 million during the three and nine months ended June 30, 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 ASC 842 lease liabilities as of June 30, 2020 are as follows (in thousands):

	<u>Principal Payments</u>	<u>Interest Payments</u>	<u>Total Payments</u>
July 2020 - June 2021	\$ 1,586	\$ 1,617	\$ 3,203
July 2021 - June 2022	1,719	1,517	3,236
July 2022 - June 2023	1,703	1,412	3,115
July 2023 - June 2024	1,738	1,310	3,048
July 2024 - June 2025	1,906	1,200	3,106
Thereafter	18,797	5,703	24,500
	<u>\$ 27,449</u>	<u>\$ 12,759</u>	<u>\$ 40,208</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 nine months ended June 30, 2020 as follows (in thousands):

	<u>Three Months Ended June 30, 2020</u>	<u>Nine Months Ended June 30, 2020</u>
Operating lease expense – fixed payments	\$ 839	\$ 2,519
Variable lease expense	158	288
Short-term equipment and other lease expense (includes \$12 and \$303 recorded in advertising and marketing, and \$72 and \$297 recorded in repairs and maintenance for the three and nine months		

ended June 30, 2020, respectively; see Note 5)		97	856
Sublease income		(2)	(8)
Total lease expense, net		<u>\$ 1,092</u>	<u>\$ 3,655</u>

Other information:

Operating cash outflows from operating leases	\$	1,051	\$	3,513
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 June 30, 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

Because of the stay-at-home order and social distancing guidelines put into place, our total revenues for the full nine-month period ended June 30, 2020 declined by 23.8% versus last year. Though we earned 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 and continue to arrange 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, including refinancing several of our debt obligations.

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. 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 nine months ended June 30, 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 and nine months ended June 30, 2020 are as follows:

Third Quarter 2020

- Total revenues were \$14.7 million compared to \$47.0 million during the comparable prior-year period, a 68.7% decrease (Nightclubs revenue of \$6.0 million compared to \$37.9 million, an 84.1% decrease; and Bombshells revenue of \$8.5 million compared to \$8.8 million, a 2.6% decrease)
- No club nor Bombshells location qualified for same-store sales
- Basic and diluted loss per share of \$0.60 compared to basic and diluted earnings per share ("EPS") of \$0.59 (non-GAAP diluted loss per share of \$0.74 compared to a non-GAAP diluted EPS* of \$0.59)
- Net cash provided by operating activities of \$166,000 compared to \$7.4 million during the comparable prior-year period, a 97.8% decrease (free cash flow* of \$166,000 compared to \$6.5 million, a 97.4% decrease)

Year-to-Date 2020

- Total revenues were \$103.5 million compared to \$135.9 million during the comparable prior-year period, a 23.8% decline (Nightclubs revenue of \$75.2 million compared to \$112.7 million, a 33.2% decrease; and Bombshells revenue of \$27.7 million compared to \$22.3 million, a 24.2% increase)
- Basic and diluted loss per share of \$0.36 compared to basic and diluted EPS of \$1.94 (non-GAAP diluted EPS* of \$0.36 compared to \$1.83, an 80.3% decrease)
- Net cash provided by operating activities of \$12.1 million compared to \$28.4 million during the comparable prior-year period, a 57.2% decrease (free cash flow* of \$10.0 million compared to \$26.3 million, a 61.9% decrease)

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

Three Months Ended June 30, 2020 Compared to Three Months Ended June 30, 2019

The following table summarizes our results of operations for the three months ended June 30, 2020 and 2019 (dollars in thousands):

	For the Three Months Ended				Increase (Decrease)	
	June 30, 2020		June 30, 2019		Amount	%
	Amount	% of Revenues	Amount	% of Revenues		
Revenues						
Sales of alcoholic beverages	\$ 7,623	51.8%	\$ 19,570	41.6%	\$ (11,947)	(61.0)%
Sales of food and merchandise	3,452	23.4%	7,046	15.0%	(3,594)	(51.0)%
Service revenues	2,907	19.7%	17,299	36.8%	(14,392)	(83.2)%
Other	739	5.0%	3,112	6.6%	(2,373)	(76.3)%
Total revenues	<u>14,721</u>	<u>100.0%</u>	<u>47,027</u>	<u>100.0%</u>	<u>(32,306)</u>	<u>(68.7)%</u>
Operating expenses						
Cost of goods sold						
Alcoholic beverages sold	1,245	16.3%	4,015	20.5%	(2,770)	(69.0)%
Food and merchandise sold	1,125	32.6%	2,565	36.4%	(1,440)	(56.1)%
Service and other	20	0.5%	121	0.6%	(101)	(83.5)%
Total cost of goods sold (exclusive of items shown separately below)	2,390	16.2%	6,701	14.2%	(4,311)	(64.3)%
Salaries and wages	5,421	36.8%	13,164	28.0%	(7,743)	(58.8)%
Selling, general and administrative	8,908	60.5%	14,895	31.7%	(5,987)	(40.2)%
Depreciation and amortization	2,235	15.2%	2,465	5.2%	(230)	(9.3)%
Other charges (gains), net	424	2.9%	(172)	(0.4)%	596	346.5%
Total operating expenses	<u>19,378</u>	<u>131.6%</u>	<u>37,053</u>	<u>78.8%</u>	<u>(17,675)</u>	<u>(47.7)%</u>
Income (loss) from operations	(4,657)	(31.6)%	9,974	21.2%	(14,631)	(146.7)%
Other income (expenses)						
Interest expense	(2,459)	(16.7)%	(2,543)	(5.4)%	(84)	(3.3)%
Interest income	80	0.5%	92	0.2%	(12)	(13.0)%
Unrealized gain (loss) on equity securities	31	0.2%	(38)	(0.1)%	69	181.6%
Income (loss) before income taxes	(7,005)	(47.6)%	7,485	15.9%	(14,490)	(193.6)%
Income tax expense (benefit)	(1,437)	(9.8)%	1,806	3.8%	(3,243)	(179.6)%
Net income (loss)	<u>\$ (5,568)</u>	<u>(37.8)%</u>	<u>\$ 5,679</u>	<u>12.1%</u>	<u>\$ (11,247)</u>	<u>(198.0)%</u>

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

Revenues

Consolidated revenues decreased by \$32.3 million, or 68.7%, due primarily to lost sales caused by the COVID-19 pandemic. No club or Bombshells location qualified for same-store sales since all units exceeded the number of closure days to be considered not comparable to prior year.

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

	For the Three Months Ended June 30,	
	2020	2019
Nightclubs	\$ 6,013	\$ 37,889
Bombshells	8,531	8,755
Other	177	383
	<u>\$ 14,721</u>	<u>\$ 47,027</u>

Changing state and local government restrictions caused by COVID-19 have kept our larger Nightclubs, particularly in Florida and New York, closed for most of the quarter. Although our Texas clubs were able to reopen in May, sales were kept to a minimum due to social distancing and occupancy requirements.

Bombshells locations were able to reopen in May 2020, but sales were limited due to indoor dining occupancy restrictions.

Operating Expenses

Total operating expenses, as a percent of revenues, increased to 131.6% from 78.8% from year-ago, with a \$17.7 million decrease, or 47.7%, which is mainly caused by fixed overhead expenses in relation to significantly lower sales. Significant contributors to the changes in operating expenses are explained below.

Cost of goods sold decreased by \$4.3 million, or 64.3%, mainly due to COVID-19-related closures and indoor dining occupancy restrictions. As a percent of total revenues, cost of goods sold increased to 16.2% from 14.2% mainly due to sales mix. Higher-margin service revenues dropped in sales mix year-over year from 36.8% to 19.7%.

Salaries and wages decreased by \$7.7 million, or 58.8%. As a percent of total revenues, salaries and wages were 36.8% from 28.0% mainly due to fixed salaries paid on significantly lower sales due to COVID-19.

Selling, general and administrative expenses decreased by approximately \$6.0 million, or 40.2%, primarily due to decreased sales activity during the quarter partially offset by fixed overhead 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 June 30, 2020. See Note 2 to our unaudited condensed consolidated financial statements.

Depreciation and amortization decreased by \$230,000, or 9.3% partly due to higher prior-year catch-up depreciation from properties moved out of held-for-sale classification.

Other charges/gains, net of \$424,000 in net charge during the current quarter compared to a net gain of \$172,000 in the prior-year quarter. The current quarter net charge was mainly from approximately \$982,000 in impairment charge, partially offset by net gains of \$608,000 on sale of one held-for-sale property and another property held and used. Last year's quarter's net gain was from the sale of two real estate properties and an aircraft amounting to \$265,000, partially offset by \$93,000 in insurance loss.

Income (Loss) from Operations

For the three months ended June 30, 2020 and 2019, our operating margin was (31.6%) and 21.2%, 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 June 30,	
	2020	2019
Nightclubs	\$ (3,088)	\$ 14,034
Bombshells	1,903	686
Other	(95)	(111)
General corporate	(3,377)	(4,365)
	<u>\$ (4,657)</u>	<u>\$ 9,974</u>

Operating margin for the Nightclubs segment was (51.4%) and 37.0% for the three months ended June 30, 2020 and 2019, respectively, while operating margin for Bombshells was 22.3% and 7.8%, respectively. The decrease in Nightclubs operating margin was mainly due to fixed operating costs and expenses in relation to lower sales from the pandemic plus the impairment charges. The increase in Bombshells operating margin was mainly from pre-opening expenses from several Bombshells openings in the prior-year quarter. Excluding impairment charges, amortization of intangibles, settlement of lawsuits, loss on insurance, and gain on disposal of assets, Nightclubs would have had non-GAAP operating margin of (43.7%) and 36.6% for the three months ended June 30, 2020 and 2019, respectively. Excluding loss on disposal of assets and amortization of intangibles, Bombshells would have had non-GAAP operating margin of 22.5% and 7.8% for the three months ended June 30, 2020 and 2019.

Non-Operating Items

Interest expense decreased by \$84,000, or 3.3%.

Our total occupancy costs, defined as the sum of lease expense and interest expense, were \$3.5 million in both current-year and prior-year third quarters but due to the significantly lower revenue in the current year, as a percentage of revenue 23.6% and 7.5% during the three months ended June 30, 2020 and 2019, respectively.

Income Taxes

Income tax benefit was \$1.4 million during the current-year third quarter compared to an income tax expense of \$1.8 million during the prior-year third quarter. The effective income tax rate was a benefit of 20.5% and an expense of 24.1%, respectively. We revised our annual forecast of pretax book income for fiscal 2020 which revised our annual effective income tax rate, for which impact was recognized in the current-year third quarter. Our effective tax rate for both years is affected by the estimate of pre-tax accounting income (loss) for the year, state taxes, permanent differences, and tax credits, including the FICA tip credit.

Nine Months Ended June 30, 2020 Compared to Nine Months Ended June 30, 2019

The following table summarizes our results of operations for the nine months ended June 30, 2020 and 2019 (dollars in thousands):

	For the Nine Months Ended				Increase (Decrease)	
	June 30, 2020		June 30, 2019		Amount	%
	Amount	% of Revenues	Amount	% of Revenues		
Revenues						
Sales of alcoholic beverages	\$ 45,285	43.7%	\$ 56,366	41.5%	\$ (11,081)	(19.7)%
Sales of food and merchandise	17,378	16.8%	19,175	14.1%	(1,797)	(9.4)%
Service revenues	34,448	33.3%	51,609	38.0%	(17,161)	(33.3)%
Other	6,430	6.2%	8,726	6.4%	(2,296)	(26.3)%
Total revenues	103,541	100.0%	135,876	100.0%	(32,335)	(23.8)%
Operating expenses						
Cost of goods sold						
Alcoholic beverages sold	8,826	19.5%	11,541	20.5%	(2,715)	(23.5)%
Food and merchandise sold	5,917	34.0%	6,857	35.8%	(940)	(13.7)%
Service and other	205	0.5%	307	0.5%	(102)	(33.2)%
Total cost of goods sold (exclusive of items shown separately below)	14,948	14.4%	18,705	13.8%	(3,757)	(20.1)%
Salaries and wages	30,866	29.8%	37,168	27.4%	(6,302)	(17.0)%
Selling, general and administrative	39,889	38.5%	43,263	31.8%	(3,374)	(7.8)%
Depreciation and amortization	6,696	6.5%	6,718	4.9%	(22)	(0.3)%
Other charges (gains), net	8,588	8.3%	(2,250)	(1.7)%	10,838	(481.7)%
Total operating expenses	100,987	97.5%	103,604	76.2%	(2,617)	(2.5)%
Income from operations	2,554	2.5%	32,272	23.8%	(29,718)	(92.1)%
Other income (expenses)						
Interest expense	(7,403)	(7.1)%	(7,709)	(5.7)%	(306)	(4.0)%
Interest income	263	0.3%	218	0.2%	45	20.6%
Unrealized loss on equity securities	(103)	(0.1)%	(408)	(0.3)%	305	74.8%
Income (loss) before income taxes	(4,689)	(4.5)%	24,373	17.9%	(29,062)	(119.2)%
Income tax expense (benefit)	(1,262)	(1.2)%	5,547	4.1%	(6,809)	(122.8)%
Net income (loss)	\$ (3,427)	(3.3)%	\$ 18,826	13.9%	\$ (22,253)	(118.2)%

* 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 \$32.3 million, or 23.8%, for the nine months ended June 30, 2020 compared to prior year primarily due to the COVID-19 pandemic.

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

	For the Nine Months Ended June 30,	
	2020	2019
Nightclubs	\$ 75,239	\$ 112,664
Bombshells	27,684	22,295
Other	618	917
	\$ 103,541	\$ 135,876

Nightclubs total sales for the nine months ended June 30, 2020 declined by 33.2% compared to a year ago because of COVID-19-related closures since March 2020.

Bombshells total sales for the nine months ended June 30, 2020 increased by 24.2% compared to a year ago mainly due to sales from two new Bombshells location, partially offset by closures due to the COVID-19 pandemic.

Operating Expenses

Total operating expenses, as a percent of revenues, increased to 97.5% from 76.2% from year-ago, with a \$2.6 million decrease, or 2.5%. Significant contributors to the changes in operating expenses are explained below.

Cost of goods sold decreased by \$3.8 million, or 20.1%, mainly due to COVID-19-related closures. As a percent of total revenues, cost of goods sold increased to 14.4% from 13.8% mainly due to perishable inventory spoilage and sales mix. Higher-margin service revenues dropped in sales mix year-over year from 38.0% to 33.3%.

Salaries and wages decreased by \$6.3 million, or 17.0%. As a percent of total revenues, salaries and wages were 29.8% from 27.4% mainly due to fixed salaries paid on significantly lower sales due to COVID-19.

Selling, general and administrative expenses decreased by \$3.4 million, or 7.8%, primarily due to decreased sales activity during the nine-month period partially offset by fixed overhead 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 nine months ended June 30, 2020. See Note 2 to our unaudited condensed consolidated financial statements.

Other charges/gains, net of \$8.6 million in net charge in the current year compared to a net gain of \$2.3 million in the prior year. The current year net charge was mainly from approximately \$9.2 million in impairment charges, partially offset by \$645,000 of net gains in the sale of real estate properties. Last year benefited from the gain on the sale of several real estate properties amounting to \$2.5 million.

Income from Operations

For the nine months ended June 30, 2020 and 2019, our operating margin was 2.5% and 23.8%, 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 Nine Months Ended June 30,	
	2020	2019
Nightclubs	\$ 13,002	\$ 44,499
Bombshells	4,166	1,543
Other	(480)	(406)
General corporate	(14,134)	(13,364)
	<u>\$ 2,554</u>	<u>\$ 32,272</u>

Operating margin for the Nightclubs segment was 17.3% and 39.5% for the nine months ended June 30, 2020 and 2019, respectively, while operating margin for Bombshells was 15.0% and 6.9%, respectively. The decrease in Nightclubs operating margin was mainly due to fixed operating costs and expenses in relation to lower sales from the pandemic 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 28.6% and 37.6% for the nine months ended June 30, 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 16.0% and 6.9% for the nine months ended June 30, 2020 and 2019, respectively.

Non-Operating Items

Interest expense decreased by \$306,000, or 4.0%.

Our total occupancy costs, defined as the sum of lease expense and interest expense, decreased to \$10.5 million from \$10.7 million in the prior year, but due to the significantly lower revenue in the current year, our total occupancy cost as a percentage of revenue increased to 10.1% from 7.8%.

Income Taxes

Income tax benefit was \$1.3 million during the current nine-month period compared to an income tax expense of \$5.5 million during the prior year. The effective income tax rate was a benefit of 26.9% and an expense of 22.8%, respectively. We revised our annual forecast of pretax book income for fiscal 2020 due to the forecasted financial impact of the COVID-19 pandemic, which revised our annual effective income tax rate. Our effective tax rate for both years is affected by the estimate of pre-tax accounting income (loss) for the year, state taxes, permanent differences, and tax credits, including the FICA tip credit.

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 26.9% and 22.8% effective tax rate of the pre-tax non-GAAP income before taxes for the nine months ended June 30, 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 nine months ended June 30, 2020 and 2019 (in thousands, except per share amounts and percentages):

	For the Three Months Ended June 30,		For the Nine Months Ended June 30,	
	2020	2019	2020	2019
Reconciliation of GAAP net income (loss) to Adjusted EBITDA				
Net income (loss) attributable to RCIHH common stockholders	\$ (5,474)	\$ 5,638	\$ (3,292)	\$ 18,717
Income tax expense (benefit)	(1,437)	1,806	(1,262)	5,547
Interest expense, net	2,379	2,451	7,140	7,491
Settlement of lawsuits	50	-	74	144
Impairment of assets	982	-	9,192	-
Gain on sale of businesses and assets	(608)	(265)	(645)	(2,487)
Unrealized loss (gain) on equity securities	(31)	38	103	408
Loss (gain) on insurance	-	93	(33)	93
Depreciation and amortization	2,235	2,465	6,696	6,718
Adjusted EBITDA	<u>\$ (1,904)</u>	<u>\$ 12,226</u>	<u>\$ 17,973</u>	<u>\$ 36,631</u>
Reconciliation of GAAP net income (loss) to non-GAAP net income (loss)				
Net income (loss) attributable to RCIHH common stockholders	\$ (5,474)	\$ 5,638	\$ (3,292)	\$ 18,717
Amortization of intangibles	149	165	462	474
Settlement of lawsuits	50	-	74	144
Impairment of assets	982	-	9,192	-
Gain on sale of businesses and assets	(608)	(265)	(645)	(2,487)
Unrealized loss (gain) on equity securities	(31)	38	103	408
Loss (gain) on insurance	-	93	(33)	93
Net income tax effect	(1,840)	(6)	(2,499)	327
Non-GAAP net income (loss)	<u>\$ (6,772)</u>	<u>\$ 5,663</u>	<u>\$ 3,362</u>	<u>\$ 17,676</u>
Reconciliation of GAAP diluted earnings (loss) per share to non-GAAP diluted earnings (loss) per share				
Diluted shares	9,125	9,620	9,224	9,671
GAAP diluted earnings (loss) per share	\$ (0.60)	\$ 0.59	\$ (0.36)	\$ 1.94
Amortization of intangibles	0.02	0.02	0.05	0.05
Settlement of lawsuits	0.01	-	0.01	0.01
Impairment of assets	0.11	-	1.00	-
Gain on sale of businesses and assets	(0.07)	(0.03)	(0.07)	(0.26)
Unrealized loss (gain) on equity securities	(0.00)	0.00	0.01	0.04
Loss (gain) on insurance	-	0.01	(0.00)	0.01
Net income tax effect	(0.20)	(0.00)	(0.27)	0.03
Non-GAAP diluted earnings (loss) per share	<u>\$ (0.74)</u>	<u>\$ 0.59</u>	<u>\$ 0.36</u>	<u>\$ 1.83</u>
Reconciliation of GAAP operating income (loss) to non-GAAP operating income (loss)				
Income (loss) from operations	\$ (4,657)	\$ 9,974	\$ 2,554	\$ 32,272
Amortization of intangibles	149	165	462	474
Settlement of lawsuits	50	-	74	144
Impairment of assets	982	-	9,192	-
Loss (gain) on insurance	-	93	(33)	93
Gain on sale of businesses and assets	(608)	(265)	(645)	(2,487)
Non-GAAP operating income (loss)	<u>\$ (4,084)</u>	<u>\$ 9,967</u>	<u>\$ 11,604</u>	<u>\$ 30,496</u>
Reconciliation of GAAP operating margin to non-GAAP operating margin				
GAAP operating margin	(31.6)%	21.2%	2.5%	23.8%
Amortization of intangibles	1.0%	0.4%	0.4%	0.3%
Settlement of lawsuits	0.3%	-	0.1%	0.1%
Impairment of assets	6.7%	-	8.9%	-
Loss (gain) on insurance	-	0.2%	(0.0)%	0.1%
Gain on sale of businesses and assets	(4.1)%	(0.6)%	(0.6)%	(1.8)%
Non-GAAP operating margin	<u>(27.7)%</u>	<u>21.2%</u>	<u>11.2%</u>	<u>22.4%</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 June 30, 2020, our cash and cash equivalents were approximately \$14.8 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 June 30, 2020, we had negative working capital of \$6.7 million compared to a negative working capital of \$2.3 million as of September 30, 2019, excluding net assets held for sale of \$2.0 million and \$2.9 million as of June 30, 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 and occupancy limitations 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 and continue to arrange 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 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, including refinancing several of our debt obligations.

We continue to adhere to state and local government mandates regarding the pandemic and, since March 2020, have closed and reopened several of our locations depending on changing government mandates. As of the release of this report, we have reopened many of our club and Bombshells locations with limited occupancy but some of our bigger clubs are still closed.

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 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.

Though our cash flows are not as we expected at the beginning of the year, the near-term outlook for our business remains strong, and we expect to generate adequate cash flows from operations for the next 12 months from the issuance of this report.

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

	For the Nine Months Ended June 30,	
	2020	2019
Operating activities	\$ 12,147	\$ 28,414
Investing activities	(1,024)	(25,608)
Financing activities	(10,425)	(9,576)
Net increase (decrease) in cash and cash equivalents	\$ 698	\$ (6,770)

Cash Flows from Operating Activities

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

	For the Nine Months Ended June 30,	
	2020	2019

Net income (loss)	\$ (3,427)	\$ 18,826
Depreciation and amortization	6,696	6,718
Deferred income tax expense (benefit)	(1,517)	1,237
Impairment of assets	9,192	-
Net change in operating assets and liabilities	(51)	3,324
Other	1,254	(1,691)
Net cash provided by operating activities	<u>\$ 12,147</u>	<u>\$ 28,414</u>

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 Nine Months Ended June 30,	
	2020	2019
Payments for property and equipment and intangible assets	\$ (5,565)	\$ (16,901)
Acquisition of businesses, net of cash acquired	-	(13,500)
Proceeds from sale of businesses and assets	2,041	5,106
Proceeds from insurance	945	-
Proceeds from notes receivable	1,555	107
Issuance of note receivable	-	(420)
Net cash used in investing activities	\$ (1,024)	\$ (25,608)

Following is a breakdown of our payments for property and equipment and intangible assets for the nine months ended June 30, 2020 and 2019 (in thousands):

	For the Nine Months Ended June 30,	
	2020	2019
New facilities, equipment and software	\$ 3,454	\$ 14,829
Maintenance capital expenditures	2,111	2,072
Total capital expenditures	\$ 5,565	\$ 16,901

The capital expenditures during the nine months ended June 30, 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 nine months ended June 30, 2019 were composed primarily of construction and development costs for four new Bombshells locations. Maintenance capital expenditures refer mainly to capitalized replacement of productive assets in already existing 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 Nine Months Ended June 30,	
	2020	2019
Proceeds from debt obligations	\$ 6,503	\$ 12,330
Payments on debt obligations	(7,489)	(18,634)
Purchase of treasury stock	(8,488)	(2,364)
Payment of dividends	(920)	(867)
Payment of loan origination costs	-	(20)
Distribution to noncontrolling interests	(31)	(21)
Net cash used in financing activities	\$ (10,425)	\$ (9,576)

Included in the \$6.5 million proceeds from debt obligations for the nine months ended June 30, 2020 are \$5.4 million in PPP loans as provided by the CARES Act.

We purchased 465,390 shares of our common stock at an average price of \$18.24 during the nine months ended June 30, 2020, while we purchased 102,113 shares of our common stock at an average price of \$23.15 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. Net cash provided by operating activities was \$166,000 and \$12.1 million during the three and nine months ended June 30, 2020, respectively, and \$7.4 million and \$28.4 million during the three and nine months ended June 30, 2019, respectively. Maintenance capital expenditures were \$0 and \$2.1 million during the three and nine months ended June 30, 2020, respectively, and \$955,000 and \$2.1 million during the three and nine months ended June 30, 2019, respectively. We use free cash flow as the baseline for the implementation of our capital allocation strategy.

Below is a table reconciling free cash flow to its most directly comparable GAAP measure (in thousands):

	For the Nine Months Ended June 30,	
	2020	2019
Net cash provided by operating activities	\$ 12,147	\$ 28,414
Less: Maintenance capital expenditures	2,111	2,072
Free cash flow	\$ 10,036	\$ 26,342

Our free cash flow for the current year decreased by 61.9% 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 nine months ended June 30 (in thousands, except percentages):

	<u>2020</u>	<u>Increase (Decrease)</u>	<u>2019</u>	<u>Increase (Decrease)</u>	<u>2018</u>
Sales of alcoholic beverages	\$ 45,285	(19.7)%	\$ 56,366	6.7%	\$ 52,835
Sales of food and merchandise	17,378	(9.4)%	19,175	13.4%	16,906
Service revenues	34,448	(33.3)%	51,609	6.8%	48,338
Other	6,430	(26.3)%	8,726	24.8%	6,993
Total revenues	103,541	(23.8)%	135,876	8.6%	125,072
Net cash provided by operating activities	\$ 12,147	(57.2)%	\$ 28,414	26.8%	\$ 22,411
Adjusted EBITDA*	\$ 17,973	(50.9)%	\$ 36,631	3.4%	\$ 35,432
Free cash flow*	\$ 10,036	(61.9)%	\$ 26,342	28.1%	\$ 20,564
Long-term debt (end of period)	\$ 142,736	(4.7)%	\$ 146,579	11.7%	\$ 131,255

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

Share Repurchase

We purchased 465,390 shares of our common stock at an average price of \$18.24 during the nine months ended June 30, 2020, while we purchased 102,113 shares of our common stock at an average price of \$23.15 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 June 30, 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 June 30, 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 two new Bombshells units during the current year, one during the first quarter ended December 31, 2019, and another during the second 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 June 30, 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 June 30, 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 June 30, 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 weakness 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 June 30, 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, we temporarily closed all of our clubs and restaurants on March 18, 2020. We furloughed club and restaurant employees, except for a limited number of unit managers, and implemented cost savings measures throughout our operations. We have since reopened many of our club and Bombshells locations with limited occupancy but some of our bigger clubs are still closed. 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 June 30, 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. During the quarter ended March 31, 2020, we purchased 132,719 shares of our common stock in the open market at prices ranging from \$8.31 to \$22.65 per share. In February 2020, the Board of Directors increased the repurchase authorization by an additional \$10.0 million. We did not purchase any shares of our common stock during the quarter ended June 30, 2020. As of August 7, 2020, we have \$11.8 million remaining to purchase additional shares.

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: August 10, 2020

By: /s/ Eric S. Langan

Eric S. Langan

Chief Executive Officer and President

Date: August 10, 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: August 10, 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: August 10, 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 June 30, 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
August 10, 2020

/s/ Phillip K. Marshall

Phillip K. Marshall
Chief Financial Officer
August 10, 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.
