

RCI Hospitality: A Misunderstood ESG Play

Part One: Rolling-up the Best Joints

RCI Hospitality, Inc. (RICK or the Company) is an entertainment company that owns 50 gentlemen's clubs and 11 sports bar restaurants. In part one, we will focus on the gentlemen's clubs and in part two, we will analyze the fast-growing sports bar segment, Bombshells.

Gentlemen's Clubs

The gentlemen's club is perhaps the world's second oldest business model. In modern lingo, it is a platform business that brings together two groups to interact in a *safe* environment. Clubs are also a signaling mechanism that reduces search costs for entertainers and clients.

RCI Hospitality's gentlemen's clubs add value to six key stakeholders—entertainers, clients, governments, lenders, selling club owners and RICK shareholders. By analyzing each stakeholder group, an investor can easily see why RICK has a wide and growing moat with a long runway, and also why it makes the world a safer place.

1) Entertainers

Entertainers are independent contractors that entertain clients by establishing a relationship built on dancing and providing a sense of companionship along with playing into client fantasies. While this can be very lucrative—entertainers can make north of \$1,000 a night—it can also be dangerous. RCI hospitality reduces the risk of harm to entertainers by monitoring the environment using security guards. Further, RICK’s security personnel and management teams know clients and screen for dangerous individuals. RICK’s greatest value-add for entertainers, perhaps, is its reputation. Entertainers know that RICK’s clubs have the best reputation in town along with the best operating controls which means it attracts the best paying, safe customers.



2) Clients

RCI Hospitality’s reputation reduces the search costs for clients looking for the most attractive women. RICK’s clubs provide an environment where guys know they will have fun and be entertained by beautiful women. Also, many of RICK’s clients are businessmen and want to have fun in a safe environment free of weapons and violence.



3) Local Government Organizations

RCI Hospitality must receive permits from local governments to operate its gentlemen's clubs. The Company needs two permits: one to operate the club and one to sell liquor. If RICK fails to get a permit or loses a permit, it will be unsuccessful. This is a double-edged sword. While RICK is always in danger of losing permits, it also benefits from regulated competition as local municipalities do not want to have an excessive number of gentlemen's clubs within their jurisdictions.

RCI Hospitality is the nation's leading gentlemen's club operator and to ensure its reputation, the Company has developed the industry's best management practices and operating controls. These include controlling illegal activities (ignoring our clever title for part one—self high five!). Municipalities would rather work with a gentlemen's club operator that has well established corporate practices than with local individuals with questionable backgrounds. Further, well maintained gentlemen's clubs that are free from drug abuse and prostitution signal that the community is upscale thereby increasing property values and tax revenues.



4) Lenders

RCI Hospitality reduces risk for lenders through diversification. RICK further reduces risk by having strict operating controls and establishing good relationships with local governments. While one club may lose a license, it is unlikely that a high number of RICK's clubs will lose their license or run into legal trouble at the same time. This is a large competitive advantage as small club owners have a difficult time obtaining financing due to undiversified risks.



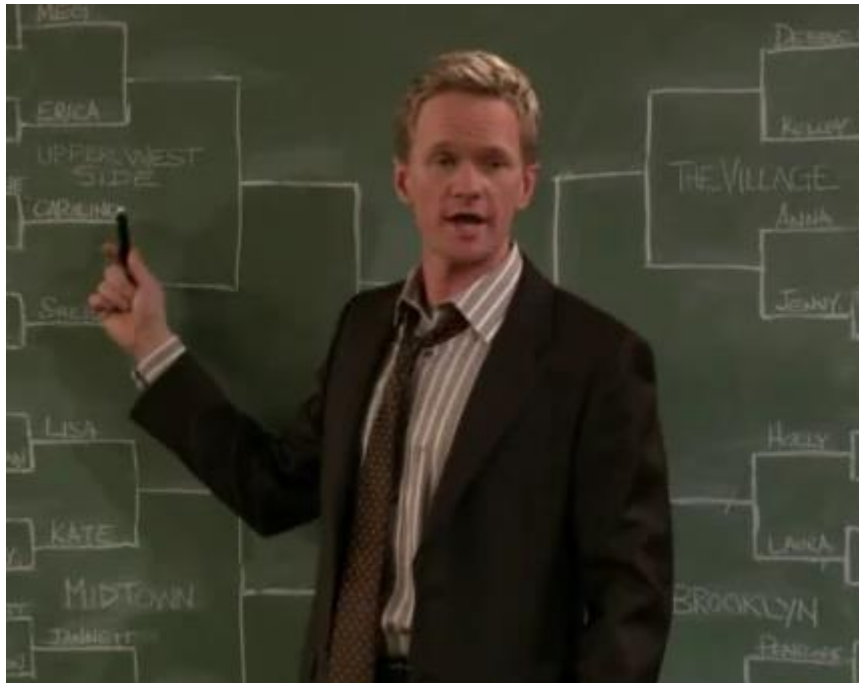
5) Selling Club Owners

Selling gentlemen’s clubs is difficult as there are limited parties interested in purchasing these assets. First, it is difficult to run a club and requires involved owners who have to put in long hours, often 16-hour shifts. Second, the risk of owning one club is high due to local licensing requirements, changes in local politics, and poor monitoring of illicit activities which reduces the selling options due to the high risk. Third, many well capitalized individuals and institutions do not want to tarnish their reputations by owning gentlemen’s clubs. These factors mean RICK is often the only reasonable purchaser of leading clubs. Also, RICK is a public company whereby sellers can receive shares in RICK for a portion of the sales price which means the seller can participate in future price appreciation along with deferring tax payments.



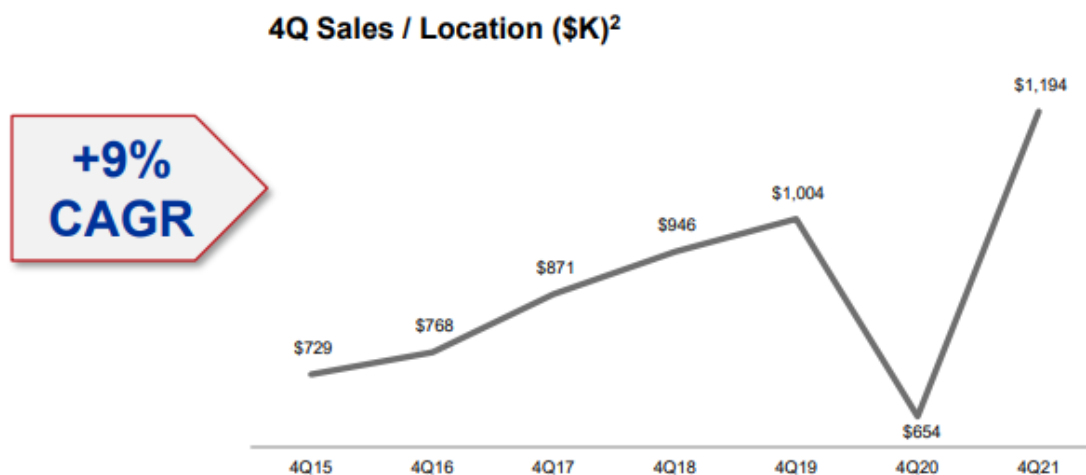
6) RICK Shareholders

In return for creating value for the above five stakeholders, RICK shareholders own a business that requires little tangible capital and yet generates significant cash flows. Like other stakeholders, RICK reduces risk and adds value for equity owners due to diversification, reputation, and excellent operating procedures.



Rick is currently rolling up the gentlemen’s club market in the United States. There are approximately 2,200 such clubs in the US and about 500 of these meet RICK’s acquisition criteria. As RICK grows the number of clubs under its ownership, its competitive advantage increases significantly.

Imagine trying to start a club in a municipality after RICK is already there and well established. You would have to get the proper permits and build a reputation among local politicians, entertainers, and clients. Good luck. Also, imagine trying to buy a club against RICK. They have better financing options (lower rates and longer terms) along with a public stock that sellers want. Again, good luck friend.



Over the last six years, RICK has increased the sales per location of its gentlemen’s clubs. It did this by first closing or selling low quality clubs and second by purchasing only the best clubs in a market. Not only does rolling-up the best joints strengthen RICK’s financial position but also solidifies its competitive advantage and reduces risk.

Club Acquisition Criteria and Returns

RICK aims to buy clubs at 3-5x EBITDA. At the beginning of FY 2022 (October 2021), RICK closed on the acquisition of an 11-club deal. The deal was valued at \$88 million including the real estate, and the consideration included \$30 million of RICK stock. The 11 clubs generated \$14 million in EBITDA giving an overall EBITDA multiple of 6.3x. The Company paid up for these clubs as it was a large purchase and significantly expanded RICK’s operating footprint into four large new markets and several smaller markets. Importantly, it immediately catapulted RCI Hospitality into the leadership position in these markets. In line with to the above analysis on the six key stakeholders, it is worth paying up for large deals with the best clubs in a market.

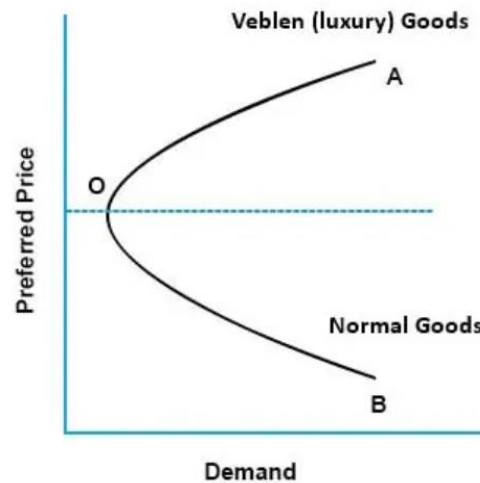
Cash-on-Cash Returns of 11 Club Acquisition Completed in October 2021			
Clubs	\$57,000	Life of Asset	Annual Depreciation
Real Estate	\$18,000	15.0	\$3,800
Intellectual Property	\$13,000	25.0	\$720
Capital Investment	\$88,000	15.0	\$867
Equity	\$37,300		\$5,387
Debt	\$50,700	Interest Rate	6.00%
Equity %	42%		
Debt %	58%		
EV/EBITDA Multiple	6.3x		5.2x
2019 EBITDA of 11 Clubs	\$14,000	EBITDA with Improvements	\$17,000
Interest	(\$3,042)	Interest	(\$3,042)
Depreciation	(\$5,387)	Depreciation	(\$5,387)
Pretax Income	\$5,571	Pretax Income	\$8,571
Taxes @ 30%	(\$1,671)	Taxes @ 30%	(\$2,571)
Net Income	\$3,900	Net Income	\$6,000
Excess Depreciation	\$3,375	Excess Depreciation	\$3,375
Cash Flow	\$7,275	Cash Flow	\$9,375
Cash-on-Cash Return	19.5%	Cash-on-Cash Return	25.1%

But wait, what about the debt repayments? Most equity analysts assume that debt repayments are forever cash outflows for RICK. This is incorrect. The value of RICK’s clubs does not depreciate. Yes, there is some maintenance capital expenditures required for the building, but this is small. For RICK’s value, it is important to understand that debt repayments are really prepayments on future acquisitions. RICK will use the equity it builds up in clubs from debt repayments to borrow against when making future purchases. And now that the Company is reaching a large scale, debt repayments and borrowings against current club equity positions will more or less equal each other in most years.

RICK in the Age of the Metaverse

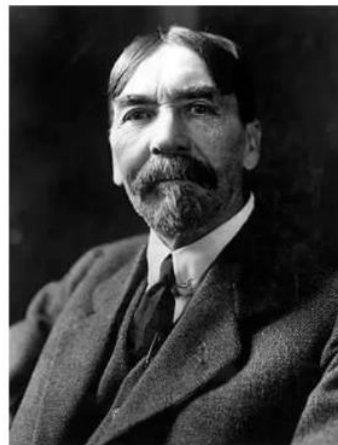
The internet and metaverse will very likely cause difficulties for lower tier gentlemen’s clubs. Clubs with less affluent clients will see pressure as these patrons migrate to the virtual world. However, the top one or two clubs in a market will actually benefit as supply contracts.

Moreover, live entertainment may achieve the status of a Veblen good where demand goes up as prices increase in world that is becoming more *regulated* and *virtual*. Men will always have a need to peacock; and as prices rise, they will feel the need to outspend their fellow man on services with contracting supply (live in person stripteases). In the future, what will be more luxurious than a *real* striptease that is difficult to obtain for the average man?



“Conspicuous Consumption”

- Thorstein Veblen
- *Theory of the Leisure Class* (1899)
- “Conspicuous Consumption” when people prefer a good **because** it is more expensive. The display of the item projects relative standing.



Further, RICK is experimenting with launching AdmireMe.com, a social platform comparable to OnlyFans. OnlyFans has big problems with ensuring the safety of its content creators many of whom may be creating content against their will; and given its limited operating infrastructure, OnlyFans has difficulty screening for such abuses. RICK, however, has management teams around the country who know the background of each content creator, thereby solving the problem of forced content creation.

RICK and the Lindy Effect

The Lindy Effect (named after a NYC delicatessen that was frequented by comedians that conducted post-mortems on recent performances) states the future life expectancy of a technology, idea or practice is proportional to its current age. Just how old are gentlemen’s clubs? Paleolithic cave paintings dating back more than 20,000 years show strippers, and archaeologists have uncovered miniature statuettes of exotic dancers dating back to the Neolithic era around 10,000 years ago. Given the longevity of the art of strip teases, it is quite likely that RICK’s business model has many years left in it.

Valuation of RCI Hospitality’s Nightclubs

Annualizing the second quarter and adjusting for improvements of recent acquisitions, Covid-19 impacts in January and February 2022, and acquisitions in the next twelve months gives a good estimate of the annual earnings power of RCI Hospitality’s Nightclubs.

Nightclub Valuation using S&P 500 Multiple		
	Q2 2022	FY 2022
Revenues	\$48,174	\$192,696
Operating Income	\$19,126	\$76,504
Share of General Corporate	(\$3,616)	(\$7,232)
Earnings before Interest	\$15,510	\$69,272
Improvement on Acquisitions + Covid Impact		\$8,000
10 New Acquisitions next 12 Months		\$8,000
Interest		(\$9,000)
Earnings before Taxes		\$76,272
Taxes @ 24%		(\$18,305)
Net Income		\$57,967
Excess Depreciation		\$5,000
Cash Flow		\$62,967
Cash Flow Multiple (= S&P 500 P/E ratio)		20.2x
Gross Value of Nightclubs		\$1,270,034
per Share Value of Nightclubs		\$134

Nightclub Valuation using Return on Incremental Capital Discounted to Present						
	2023	2024	2025	2026	2027	2028
Nightclub Cash Flow	\$62,967	\$75,560	\$90,672	\$108,806	\$130,567	\$156,681
New Invested Capital	\$62,967	\$75,560	\$90,672	\$108,806	\$130,567	
Return On Invested Capital	20%	20.0%	20.0%	20.0%	20.0%	
Incremental Cash Flow	\$12,593	\$15,112	\$18,134	\$21,761	\$26,113	
P/Forward CF Multiple in 2028						20.2x
Discount Rate	10%					\$3,160,252
Equity Value Today						\$1,962,268
per Share Value						\$206

The equity value of the Company’s Nightclubs is approximately \$134 to \$206 per share versus the current share price of \$59. \$206 may seem high but remember there are 500 potential clubs to be purchased in the rollup strategy versus current clubs and cash flows of approximately 50 and \$64 million. Also, RICK’s risk is declining with each purchase and the valuation ignores the huge optionality in AdmireMe.

Lindy, Lindy, Lindy, Lindy, Lindy, Lindy, Lindy, Lindy.....

Part Two: Scoring with Growth

“Why has that man fallen in love with that woman? Because she’s pretty. Why does pretty matter? Because human beings are a mainly monogamous species and so males are choosy about their mates (as male chimpanzees are not); prettiness is an indication of youth and health, which are indications of fertility. Why does that man care about fertility in his mate? Because if he did not, his genes would be eclipsed by those of men who did. Why does he care about that?

He does not, but his genes act as if they do. Those who choose infertile mates leave no descendants. Therefore, everybody is descended from men who preferred fertile women, and every person inherits from those ancestors the same preference.”

— Matt Ridley, The Red Queen: Sex and the Evolution of Human Nature

Bombshells

RICK's Bombshells segment is a next generation sports bar. It has high quality food, big TVs, and serves customers during for four distinct time periods: lunch, happy hour, dinner and late night. It appeals to wide audiences including men, women, families, friends, singles, couples and millennials. It uses self marketing (attractive servers) to gain customers. The average restaurant size is 10,000 to 12,500 square feet including patio and requires a cash investment of \$3-\$5 million including owned real estate.



RCI Hospitality is targeting 15 new Bombshells locations in the next three years with potential of 80-100 company owned and franchised locations throughout the United States with a focus on the South including Texas, Florida, Alabama, and Arizona.

The concept was launched in 2013. In the early years, RICK struggled to make the concept very profitable. However, it has greatly improved cash flow from operations in recent years by selecting better real estate and optimizing the food and drink mix along with better hours of operations.

Bombshells Valuation

Bombshells Valuation					
	2022	2023	2024	2025	2026
Franchises	1	3	7	10	13
Sales per Unit	\$5,000	\$5,000	\$5,000	\$5,000	\$5,000
Total Franchise Sales	\$5,000	\$15,000	\$35,000	\$50,000	\$65,000
Royalty Rate	5.5%	5.5%	5.5%	5.5%	5.5%
Franchise Fees	\$275	\$825	\$1,925	\$2,750	\$3,575
Company Owned Units	10	13	16	20	25
Operating Income per Unit	\$1,326	\$1,326	\$1,326	\$1,326	\$1,326
Company Owned Operating Income	\$13,260	\$17,238	\$21,216	\$26,520	\$33,150
Bombshells Operating Income	\$13,535	\$18,063	\$23,141	\$29,270	\$36,725
Interest Expense	(\$2,200)	(\$2,860)	(\$3,520)	(\$4,400)	(\$5,500)
Bombshells EBT	\$11,335	\$15,203	\$19,621	\$24,870	\$31,225
Taxes @ 30%	(\$3,401)	(\$4,561)	(\$5,886)	(\$7,461)	(\$9,368)
Bombshells Net Income	\$7,935	\$10,642	\$13,735	\$17,409	\$21,858
Terminal Value at 15x					\$441,522
Discount Value at 10%	\$7,213	\$8,795	\$10,319	\$11,891	\$287,722
Total Discounted Value	\$325,940				
per Share Value of Bombshells	\$34				

Bombshells									
	2013	2014	2015	2016	2017	2018	2019	2020	2021
Revenues	\$1,870	\$5,770	\$17,640	\$18,690	\$18,830	\$24,090	\$30,830	\$43,220	\$56,620
Operating Income	(\$30)	(\$320)	\$1,640	\$1,150	\$3,080	\$2,040	\$2,310	\$9,240	\$13,260
Units	2	4	5	4	5	6	8	10	10
Revenue per Unit	\$935	\$1,443	\$3,528	\$4,673	\$3,766	\$4,015	\$3,854	\$4,322	\$5,662
Operating Income per Unit	(\$15)	(\$80)	\$328	\$288	\$616	\$340	\$289	\$924	\$1,326

Bombshells Valuation					
	2022	2023	2024	2025	2026
Franchises	1	3	10	20	30
Sales per Unit	\$5,000	\$5,000	\$5,000	\$5,000	\$5,000
Total Franchise Sales	\$5,000	\$15,000	\$50,000	\$100,000	\$150,000
Royalty Rate	5.5%	5.5%	5.5%	5.5%	5.5%
Franchise Fees	\$275	\$825	\$2,750	\$5,500	\$8,250
Company Owned Units	10	13	18	25	30
Operating Income per Unit	\$1,326	\$1,326	\$1,326	\$1,326	\$1,326
Company Owned Operating Income	\$13,260	\$17,238	\$23,868	\$33,150	\$39,780
Bombshells Operating Income	\$13,535	\$18,063	\$26,618	\$38,650	\$48,030
Interest Expense	(\$2,200)	(\$2,860)	(\$3,960)	(\$5,500)	(\$6,600)
Bombshells EBT	\$11,335	\$15,203	\$22,658	\$33,150	\$41,430
Taxes @ 30%	(\$3,401)	(\$4,561)	(\$6,797)	(\$9,945)	(\$12,429)
Bombshells Net Income	\$7,935	\$10,642	\$15,861	\$23,205	\$29,001
Terminal Value at 30x					\$870,030
Discount Value at 10%	\$7,213	\$8,795	\$11,916	\$15,849	\$558,228
Total Discounted Value	\$602,001				
per Share Value of Bombshells	\$63				

RCI Hospitality's Bombshell segment is more uncertain than its Nightclub segment. However, the concept has great potential and adds significant value to RICK shares.

Adding up the Nightclub and Bombshells segments gives a value range of \$168 to \$269 per share.