

KONA GRILL INC  
Form 10-Q  
November 01, 2016

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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

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**FORM 10-Q**

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

**For the quarterly period ended September 30, 2016**

or

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

Commission File Number 001-34082

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**Kona Grill, Inc.**  
*(Exact Name of Registrant as Specified in Its Charter)*

**Delaware**

**20-0216690**

*(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)*

**7150 East Camelback Road, Suite 333**

**Scottsdale, Arizona 85251**

**(480) 922-8100**

*(Address, including zip code, and telephone number, including area code, of principal executive offices)*

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 and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted 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 and post 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. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

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 October 31, 2016, there were 10,542,278 shares of the registrant’s common stock outstanding.



**KONA GRILL, INC.**

**TABLE OF CONTENTS**

**Page**

**PART I. FINANCIAL INFORMATION**

Item 1. Financial Statements	
Condensed Consolidated Balance Sheets as of September 30, 2016 (Unaudited) and December 31, 2015	2
Condensed Consolidated Statements of Comprehensive Income (Loss) for the Three and Nine Months Ended September 30, 2016 and 2015 (Unaudited)	3
Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2016 and 2015 (Unaudited)	4
Notes to Condensed Consolidated Financial Statements	5
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	12
Item 3. Quantitative and Qualitative Disclosures About Market Risk	22
Item 4. Controls and Procedures	23

**PART II. OTHER INFORMATION**

Item 1. Legal Proceedings	23
Item 1A. Risk Factors	23
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	23
Item 3. Defaults Upon Senior Securities	23
Item 4. Mine Safety Disclosures	23
Item 5. Other Information	24
Item 6. Exhibits	24

**PART I – FINANCIAL INFORMATION****Item 1. Financial Statements****KONA GRILL, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except share data)

	<b>September 30,</b>	<b>December 31,</b>
	<b>2016</b>	<b>2015</b>
	(Unaudited)	(Note 1)
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 6,143	\$ 9,055
Short-term investments	178	178
Receivables	2,905	1,574
Inventory	2,041	1,865
Prepaid expenses and other current assets	792	774
Total current assets	12,059	13,446
Other assets	1,172	1,146
Property and equipment, net	107,907	87,252
Total assets	\$ 121,138	\$ 101,844
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 3,599	\$ 4,548
Accrued expenses	15,029	14,282
Total current liabilities	18,628	18,830
Long term debt	25,000	—
Deferred rent and other long term liabilities	28,562	20,323
Total liabilities	72,190	39,153
Commitments and contingencies (Note 10)		
Stockholders' equity:		
Preferred stock, \$0.01 par value, 2,000,000 shares authorized, none issued	—	—

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Common stock, \$0.01 par value, 30,000,000 shares authorized, 10,658,478 shares issued and 10,542,278 shares outstanding at September 30, 2016; 11,387,724 shares issued and 11,271,524 shares outstanding at December 31, 2015	107	114
Additional paid-in capital	89,492	98,182
Accumulated deficit	(39,651 )	(34,605 )
Treasury stock, at cost, 116,200 shares at September 30, 2016 and December 31, 2015	(1,000 )	(1,000 )
Total stockholders' equity	48,948	62,691
Total liabilities and stockholders' equity	\$ 121,138	\$ 101,844

See accompanying notes to condensed consolidated financial statements.

**KONA GRILL, INC.****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)****(in thousands, except per share data)****(unaudited)**

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
Restaurant sales	\$43,358	\$35,925	\$125,931	\$104,957
Costs and expenses:				
Cost of sales	11,602	9,812	33,316	28,552
Labor	16,005	12,687	45,602	36,471
Occupancy	3,499	2,638	10,006	7,496
Restaurant operating expenses	6,269	5,238	17,973	14,824
General and administrative	3,127	3,101	9,980	9,527
Preopening expenses	1,430	1,379	3,443	3,302
Depreciation and amortization	3,837	2,471	10,338	6,945
Other expenses	—	—	—	161
Total costs and expenses	45,769	37,326	130,658	107,278
Income (loss) from operations	(2,411 )	(1,401 )	(4,727 )	(2,321 )
Interest expense, net	138	42	263	133
Income (loss) before income taxes	(2,549 )	(1,443 )	(4,990 )	(2,454 )
Income tax expense	6	25	56	32
Net income (loss)	\$(2,555 )	\$(1,468 )	\$(5,046 )	\$(2,486 )
Net income (loss) per share:				
Basic	\$(0.24 )	\$(0.13 )	\$(0.46 )	\$(0.22 )
Diluted	\$(0.24 )	\$(0.13 )	\$(0.46 )	\$(0.22 )
Weighted average shares used in computation:				
Basic	10,500	11,277	10,897	11,261
Diluted	10,500	11,277	10,897	11,261
Comprehensive income (loss)	\$(2,555 )	\$(1,468 )	\$(5,046 )	\$(2,486 )

See accompanying notes to condensed consolidated financial statements.





**KONA GRILL, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(unaudited)**

	<b>Nine Months Ended September 30,</b>	
	<b>2016</b>	<b>2015</b>
<b>Operating activities</b>		
Net income (loss)	\$(5,046 )	\$(2,486 )
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	10,338	6,945
Stock-based compensation	942	1,019
Amortization of deferred financing costs	62	61
Change in operating assets and liabilities:		
Receivables	(1,330 )	(1,558 )
Inventory	(176 )	(121 )
Prepaid expenses and other current assets	(18 )	111
Accounts payable	(78 )	(510 )
Accrued expenses	1,541	(16 )
Deferred rent and other long term liabilities	8,239	3,351
Net cash provided by operating activities	14,474	6,796
<b>Investing activities</b>		
Purchase of property and equipment	(32,659)	(28,062)
Change in other assets	(88 )	(83 )
Net cash used in investing activities	(32,747)	(28,145)
<b>Financing activities</b>		
Borrowings under credit facility	25,000	—
Purchase and retirement of common stock	(9,773 )	—
Proceeds from issuance of common stock under the Employee Stock Purchase Plan and exercise of stock options	358	554
Payment for withholding tax from net settled stock option exercise	(224 )	—
Net cash provided by financing activities	15,361	554
Net change in cash and cash equivalents	(2,912 )	(20,795)
Cash and cash equivalents at the beginning of the period	9,055	36,578
Cash and cash equivalents at the end of the period	\$6,143	\$15,783
<b>Supplemental disclosure of cash flow information</b>		
Cash paid for interest, net of capitalized interest	\$145	\$76

Cash paid for income taxes, net of refunds	\$18	\$32
<b>Noncash investing activities</b>		
Accounts payable and accruals related to property and equipment	\$5,601	\$7,671

See accompanying notes to condensed consolidated financial statements.

**KONA GRILL, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**1. Basis of Presentation**

Kona Grill, Inc., including its wholly-owned subsidiaries, (referred to herein as the “Company” or “we,” “us,” and “our”) develops, owns and operates upscale casual dining restaurants under the name “Kona Grill.” Our restaurants feature a global menu of contemporary American favorites, award-winning sushi, and specialty cocktails. As of September 30, 2016, we owned and operated 42 restaurants in 22 states and Puerto Rico. Our chief operating decision maker function is comprised of our Chief Executive Officer and Chief Financial Officer who manage our restaurant operation base that aggregates into one reportable segment. Accordingly, we have a single operating segment and reporting unit structure.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“U.S. GAAP”) for interim financial information and with the rules and regulations of the U.S. Securities and Exchange Commission (“SEC”). Accordingly, they do not include all of the information and notes required by U.S. GAAP for complete financial statements. In our opinion, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016.

The consolidated balance sheet at December 31, 2015 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and notes required by U.S. GAAP for complete financial statements. Accordingly, these financial statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2015. Certain reclassifications of prior year’s financial statement amounts have been made to conform to the current year presentation.

The Company has evaluated subsequent events and transactions for potential recognition or disclosure in the financial statements through the day the financial statements are issued.

In February and April 2016, we entered into franchise agreements for the development of six Kona Grill restaurants in Mexico and six restaurants in the United Arab Emirates. Territory and franchise fees received in conjunction with these agreements are recorded as deferred revenue and included in “Deferred rent and other long term liabilities” in our

consolidated balance sheets. Territory fees are recognized as income on a pro-rata basis at the same time the individual franchise fees for each location are considered earned, typically when the individual franchise unit is opened. We have not recognized any franchise related income in the nine months ended September 30, 2016.

### ***Recently Issued Accounting Standards***

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The pronouncement was issued to clarify the principles for recognizing revenue and is effective for reporting periods beginning after December 15, 2017. The expected adoption method of ASU 2014-09 is being evaluated by the Company.

In April 2015, the FASB issued ASU 2015-03, *Interest – Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*. This guidance requires debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying value of that debt liability. However, the guidance in ASU 2015-15, issued in August 2015, *Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements*, prescribes that deferred initial up-front commitment fees paid by a borrower to a lender represent the benefit of being able to access capital over the contractual term, and therefore, meet the definition of an asset, while debt issuance costs in the scope of ASU 2015-03 do not. As such, the Company will continue to present the costs associated with its asset-based revolving credit facility as an asset. Debt issuance costs associated with the Company’s asset-based revolving credit facility of \$260,000 as of September 30, 2016 are included in prepaid expenses and other current assets and other assets in the condensed consolidated balance sheet.

In April 2015, the FASB issued ASU No. 2015-05, *Intangibles – Goodwill and Other – Internal-Use Software (Subtopic 350-40)*. The pronouncement was issued to provide guidance concerning accounting for fees in a cloud computing arrangement. We have elected to adopt the guidance prospectively. The adoption of ASU 2015-05 in the first quarter of 2016 did not have a significant impact on our consolidated financial position or results of operations.

In February 2016, a new accounting standard, ASC Topic 842, “Leases,” was issued to increase the transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. In order to meet that objective, the new standard requires recognition of the assets and liabilities that arise from leases. Accordingly, a lessee will recognize a right-of-use (ROU) asset for its right to use the underlying asset and a lease liability for the corresponding lease obligation. Both the ROU asset and lease liability will initially be measured at the present value of the future minimum lease payments over the lease term. Subsequent measurement, including the presentation of expenses and cash flows, will depend on the classification of the lease as either finance or an operating lease. Initial costs directly attributable to negotiating and arranging the lease will be included in the ROU asset. Lessees can make an accounting policy election by class of underlying asset not to recognize a ROU asset and corresponding lease liability for leases with a term of 12 months or less. Accounting by lessors will remain largely unchanged from current U.S. GAAP. In transition, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. The modified retrospective approach includes a number of optional practical expedients that companies may elect to apply. These practical expedients relate to the identification and classification of leases that commenced before the effective date, initial direct costs for leases that commenced before the effective date, and the ability to use hindsight in evaluating lessee options to extend or terminate a lease or to purchase the underlying asset. The transition guidance also provides specific guidance for sale and leaseback transactions, build-to-suit leases, leveraged leases, and amounts previously recognized in accordance with the business combinations guidance for leases. The new standard is effective for public companies for fiscal years beginning after December 15, 2018, and interim periods within those years, with early adoption permitted. The expected adoption method is being evaluated by our company. We expect the adoption of this guidance to have a material impact on our consolidated financial position and results of operations.

In March 2016, the FASB issued ASU 2016-09, *Compensation - Stock Compensation (Topic 718)* which simplifies the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. The standard is effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years, with early adoption permitted. We are currently evaluating the timing and the impact of adopting the standard.

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows – Classification of Certain Cash Receipts and Cash Payments* as stakeholders indicated that there is diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows under Topic 230, *Statement of Cash Flows*, and other Topics. This ASU addressed eight specific cash flow issues with the objective of reducing the existing diversity in practice. The amendments are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. The amendments should be applied using a retrospective transition method to each period presented. We are currently evaluating the timing and the impact of adopting the standard, as the amendments in this ASU could impact the way we report certain items in our statement of cash flows.

## 2. Fair Value Measurements

The carrying value for certain of our financial instruments, including cash and cash equivalents, accounts receivable and accounts payable approximates fair value because of their short-term nature. Our investments represent certificates of deposit and are considered available-for-sale securities that are valued using market observable inputs (Level 2). Our long-term debt is valued using primarily Level 2 inputs including current applicable rates for similar instruments and approximates the carrying value of such obligations.

### 3. Net Income (Loss) Per Share

Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share includes the dilutive effect of potential stock option exercises, calculated using the treasury stock method.

The following table sets forth the computation of basic and diluted net income (loss) per share:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30, 2016</b>	<b>2015</b>	<b>September 30, 2016</b>	<b>2015</b>
	(In thousands, except per share data)			
Numerator:				
Net income (loss)	\$ (2,555 )	\$ (1,468 )	\$ (5,046 )	\$ (2,486 )
Denominator:				
Weighted average shares — Basic	10,500	11,277	10,897	11,261
Effect of dilutive stock options	—	—	—	—
Weighted average shares — Diluted	10,500	11,277	10,897	11,261
Net income (loss) per share:				
Basic	\$ (0.24 )	\$ (0.13 )	\$ (0.46 )	\$ (0.22 )
Diluted	\$ (0.24 )	\$ (0.13 )	\$ (0.46 )	\$ (0.22 )

Stock options outstanding that were not included in the dilutive earnings per share calculation because the effect would have been anti-dilutive were 658,000 and 356,000, respectively, for the three months ended September 30, 2016 and 2015, and 694,000 and 291,000, respectively, for the nine months ended September 30, 2016 and 2015.

### 4. Property and Equipment

Property and equipment consisted of the following (in thousands):

<b>September 30,</b>	<b>December 31,</b>
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	<b>2016</b>	<b>2015</b>
Leasehold improvements	\$ 118,903	\$ 96,473
Equipment	31,451	25,825
Furniture and fixtures	13,724	11,126
	164,078	133,424
Less accumulated depreciation and amortization	(64,373 )	(54,027 )
	99,705	79,397
Construction in progress	8,202	7,855
Total property and equipment, net	\$ 107,907	\$ 87,252

We capitalize direct internal payroll and travel costs on the construction of leasehold improvements incurred during the development and construction period. Capitalized costs were \$395,000 and \$197,000 in the three months ended September 30, 2016 and 2015, respectively, and \$1,018,000 and \$577,000 in the nine months ended September 30, 2016 and 2015, respectively.



## 5. Accrued Expenses

Accrued expenses consisted of the following (in thousands):

	<b>September 30,</b>	<b>December 31,</b>
	<b>2016</b>	<b>2015</b>
Accrued payroll and benefits	\$ 4,582	\$ 3,786
Accrued construction and remodel costs <sup>(1)</sup>	4,221	5,017
Gift card liability	2,359	2,309
Sales taxes	1,764	1,678
Accrued occupancy	578	296
Business and income taxes	455	321
Other	1,070	875
Total accrued expenses	\$ 15,029	\$ 14,282

(1) Balance is attributable to property additions for our new restaurants and remodels.

## 6. Debt and Credit Agreements

On April 19, 2013, we entered into a Credit Agreement for a \$20 million revolving line of credit maturing on April 19, 2017 with KeyBank National Association (“KeyBank”) and Stearns Bank National Association (“Stearns Bank”). On November 7, 2014, we entered into an Amended and Restated Credit Agreement (the “Amended Credit Agreement”) with KeyBank to (i) increase the credit facility from \$20 million to \$35 million, and (ii) extend the maturity date of the credit facility to November 7, 2019. On October 12, 2016, we entered into the Second Amended and Restated Credit Agreement (the “Second Amended Credit Agreement”) with KeyBank and Zions First National Bank. See Note 11 “Subsequent Event”.

The interest rate under the Amended Credit Agreement is KeyBank’s prime rate or LIBOR, at our option, plus an applicable margin depending on our leverage ratio. The LIBOR margins range from 1.5% to 2.5% and the base rate margins range from 0.5% to 1.5%. Payments on the credit facility are interest only, payable quarterly with respect to each base rate loan and at varying times with respect to LIBOR rate loans, with outstanding principal and interest due at maturity. Prepayment is permitted at any time without penalty, subject to certain restrictions on the order of repayment or prepayment. We are obligated to pay a commitment fee at an annual rate of 0.175% to 0.350%, depending on our leverage ratio, times the unused total revolving commitment of the credit facility based on the average daily amount outstanding under the credit facility for the previous quarter. The commitment fee is payable quarterly in arrears.

At September 30, 2016, prior to the execution of the Second Amended Credit Agreement, we had \$25 million in outstanding borrowings and \$10 million available under the credit facility, subject to compliance with certain covenants. We incurred gross interest expense of \$138,000 and \$43,000 during the quarter ended September 30, 2016 and 2015, consisting of interest incurred on borrowings of \$236,000 and none, respectively, loan fee amortization of \$21,000 and \$21,000, respectively, and commitment fees of \$11,000 and \$22,000, respectively. Gross interest expense of \$264,000 and \$137,000 during the nine months ended September 30, 2016 and 2015 consisted of interest incurred on borrowings of \$271,000 and none, respectively, loan fee amortization of \$62,000 and \$61,000, respectively, and commitment fees of \$57,000 and \$66,000, respectively. Unamortized loan fees of \$260,000 at September 30, 2016 are amortized over the life of the credit facility and are included in prepaid expenses and other current assets, and other assets in the condensed consolidated balance sheet. Capitalized interest was \$66,000 and \$126,000 for the three and nine months ended September 30, 2016, respectively. We did not capitalize any interest for the three and nine months ended September 30, 2015.

Our current projections indicate that we will maintain the outstanding borrowings for the next 12 months and, as a result, all borrowings under the credit facility are classified as long-term debt.

The credit facility also requires us to comply with certain covenants, including (a) a fixed charge coverage ratio of not less than 1.50 and (b) a maximum leverage ratio of 5.0 to 1.0 through March 31, 2016 and 4.75 to 1.0 from April 1, 2016 through the maturity date. On August 1, 2016, we entered into Amendment No.1 to the Amended Credit Agreement with KeyBank to amend certain components of the leverage ratio calculation to provide us with increased borrowing flexibility under the credit facility and amending certain other financial covenants. Under Amendment No. 1, the covenants continued to require a fixed charge coverage ratio of not less than 1.50. As amended, the covenants included a maximum leverage ratio of 4.25 to 1.0 through the maturity date. On September 26, 2016, KeyBank issued a waiver related to the fixed charge coverage ratio for the three months ended June 30, 2016 and September 30, 2016. In the Second Amended Credit Agreement entered into on October 12, 2016, (see Note 11, "Subsequent Events") certain components of the fixed charge coverage ratio have been revised to address the component that necessitated the waiver. Other than the fixed charge coverage ratio for the three months ended September 30, 2016, for which we obtained a waiver, we were in compliance with all covenants at September 30, 2016.

## **7. Income Taxes**

We recorded income tax expense of \$6,000 and \$25,000 during the three months ended September 30, 2016 and 2015, and \$56,000 and \$32,000 during the nine months ended September 30, 2016 and 2015, respectively. The income tax expense for the three and nine months ended September 30, 2016 and 2015 consists of state income tax expenses for which no net operating losses or other credits exist. The income tax expense for the nine months ended September 30, 2015 also includes refunds primarily associated with prior year state income tax.

At September 30, 2016, we had approximately \$21 million in deferred tax assets primarily related to net operating loss carryforwards and federal business tax credit carryforwards. We have a full valuation allowance for these carryforwards due to the uncertainty surrounding their future utilization. The realization of our deferred tax assets ultimately depends on the existence of sufficient taxable income in the appropriate taxing jurisdictions in future periods. We have analyzed, and will continue to analyze, the positive and negative evidence to support our conclusion regarding the appropriate amount of our valuation allowance. The valuation allowance could be reduced in a subsequent period if there is sufficient evidence to support a conclusion that it is more likely than not that the net operating loss carryforwards and/or the federal business tax credit carryforwards will be realized. Future changes in our valuation allowance could have a material effect on our results of operations in the period recorded.

## **8. Stock-Based Compensation**

The fair value of stock options granted during the nine months ended September 30, 2016 and 2015 was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

**Nine Months  
Ended September  
30,  
2016      2015**

Expected volatility	45.2%	40.7%
Risk-free interest rate	0.9 %	0.9 %
Expected option life (in years)	3.2	3.0
Dividend yield	0.0 %	0.0 %
Weighted average fair value per option granted	\$4.57	\$6.67

The following table summarizes our stock option activity for the nine months ended September 30, 2016:

	<b>Options</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Term (in years)</b>	<b>Aggregate Intrinsic Value</b>
Outstanding options at December 31, 2015	961,468	\$ 15.15		
Granted	251,532	14.26		
Forfeited	(96,994 )	10.73		
Exercised	(82,206 )	6.75		
Outstanding options at September 30, 2016	1,033,800	\$ 16.02	2.8	\$1,116,000
Exercisable at September 30, 2016	526,117	\$ 13.58	2.0	\$976,000

We recognized stock-based compensation expense of \$320,000 and \$356,000 in the three months ended September 30, 2016 and 2015, respectively, and \$942,000 and \$1,019,000 in the nine months ended September 30, 2016 and 2015, respectively. As of September 30, 2016, there was \$2,157,000 of unrecognized stock-based compensation expense related to unvested stock-based compensation awards, which is expected to be recognized over a weighted average period of 2.4 years.

The total shares of common stock reserved for issuance totaled 3,700,000, of which 1,412,000 shares were available for grant as of September 30, 2016.

## **9. Stock Purchase Program and Stockholders Rights Plan**

In November 2015, our Board of Directors authorized a repurchase program of up to \$10 million of our outstanding common stock. We completed the \$10 million stock repurchase program in June 2016 with the purchase and retirement of 832,937 shares under the 2015 authorization.

In October 2016, our Board of Directors authorized an additional stock repurchase of up to \$5,000,000 of outstanding common stock.

On September 6, 2016, our Board of Directors approved the declaration of a dividend of one purchase right (a "Right") for each outstanding share of common stock, par value \$0.01 per share, of the Company (the "Common Stock"). Each Right entitles the registered holder to purchase from the Company one one-thousandth of a share of preferred stock of the Company (the "Preferred Stock") at a price of \$55.94 per share (the "Purchase Price"), subject to adjustment, under certain conditions specified in the Rights Agreement. Rights will be exercisable only if a person or group acquires 9.9% or more of the Company's common stock (subject to certain exceptions), and thus becomes an "Acquiring Person" under the Rights Plan. In the event that any person or group of affiliated or associated persons becomes an Acquiring Person, each holder of a Right, other than Rights beneficially owned by the Acquiring Person, affiliates and associates of the Acquiring Person and certain transferees thereof (which will thereupon become null and void), will thereafter have the right to receive upon exercise of a Right, for the exercise price of the Right, in lieu of preferred stock, shares of Common Stock of the Company having a market value equal to twice such exercise price. The Rights are not exercisable until the Distribution Date, as defined in the Rights Agreement filed on Form 8-K on September 6, 2016. The Rights will expire on September 6, 2019, unless the Rights are earlier redeemed or exchanged by the Company, or upon the occurrence of certain transactions.

## **10. Commitments and Contingencies**

We are engaged in various legal actions, which arise in the ordinary course of our business. Although there can be no assurance as to the ultimate disposition of these matters, it is the opinion of our management, based upon the information available at this time, that the expected outcome of these matters, individually or in the aggregate, will not have a material adverse effect on the results of operations or financial condition of our company.

On December 13, 2012, Frank Neal Goss filed a lawsuit against Kona Grill Macadamia, Inc., a wholly-owned subsidiary of the Company (“Macadamia”) and Anthony DeAngelo in the Circuit Court of Jackson County, Kansas City, Missouri. The claim revolves around a fight that Goss and DeAngelo allegedly had outside of the Company’s Kansas City restaurant on March 1, 2011, which is claimed to have resulted in physical injury to the plaintiff. The plaintiff also claims that Macadamia failed to take certain actions that allegedly would have prevented the fight. A default judgment of approximately \$3.5 million was entered on December 18, 2013 against Macadamia, but was subsequently set aside by order of the Circuit Court on April 7, 2014. On August 17, 2015, Macadamia filed a Motion for Summary Judgment requesting judgment in its favor on all claims asserted against it by the plaintiff. On August 18, 2015, the plaintiff filed for a voluntary dismissal of the claim without prejudice; however, on April 22, 2016, the plaintiff re-filed the claim in the Circuit Court. The case is proceeding in the Circuit Court and a trial date has been set for June 12, 2017. We believe that we have a strong defense to the claim asserted by the plaintiff and insurance coverage for the claim.

## 11. Subsequent Event

On October 12, 2016, we entered into the Second Amended and Restated Credit Agreement (the “Second Amended Credit Agreement”) with KeyBank and Zions First National Bank to (i) increase the credit facility from \$35 million to \$60 million, comprised of a \$45 million revolver (“Revolver”) and \$15 million term loan (“Term Loan”), and (ii) extend the maturity date of the credit facility to October 12, 2021. The credit facility is secured by our personal property and assets. Certain of our wholly owned subsidiaries have also guaranteed the credit facility.

The interest rate under the Second Amended Credit Agreement is KeyBank’s base rate or LIBOR, at our option, plus an applicable margin depending on our leverage ratio. The LIBOR margins range from 1.75% to 2.75% and the base rate margins range from 0.75% to 1.75%. Payments on the Term Loan are due quarterly and subject to acceleration upon certain events as defined in the Second Amended Credit Agreement, while borrowings on the Revolver are interest only, payable quarterly with respect to each base rate loan and at varying times with respect to LIBOR rate loans, with outstanding principal and interest due at maturity. Prepayment is permitted at any time without penalty, subject to certain restrictions on the order of repayment or prepayment. We are obligated to pay a commitment fee at an annual rate of 0.175% to 0.350%, depending on our leverage ratio, times the unused total revolving commitment of the credit facility based on the average daily amount outstanding under the credit facility for the previous quarter. The commitment fee is payable quarterly in arrears.

The credit facility also requires us to comply with certain covenants, including (a) a fixed charge coverage ratio of not less than 1.50 and (b) a maximum leverage ratio of 4.25 to 1.0 through the maturity date. We may from time to time request that the total revolving credit commitment under the Second Amended Credit Agreement be increased up to an amount not to exceed \$85 million. Any such increase is subject to agreement of the respective lenders in the lending syndicate or new lenders in certain circumstances. Any such increase, which may be for a lesser amount than requested by us, is also subject to certain other terms and conditions as provided in the Second Amended Credit Agreement.

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

The following discussion and analysis should be read in conjunction with the unaudited condensed consolidated financial statements and notes thereto included in Item 1 of Part I of this Form 10-Q and the audited consolidated financial statements and notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations for the year ended December 31, 2015 contained in our 2015 Annual Report on Form 10-K.

Certain information included in this discussion contains forward-looking statements that involve known and unknown risks and uncertainties, such as statements relating to our future economic performance, plans and objectives for future operations, expectations, intentions and other financial items that are based on our beliefs as well as assumptions made by and information currently available to us. Factors that could cause actual events or results to differ materially from those indicated by these forward-looking statements may include the matters under Item 1A, "Risk Factors" in this report, our Annual Report on Form 10-K for the year ended December 31, 2015 and other reports filed from time to time with the SEC.

**Overview**

We currently own and operate 43 restaurants located in 23 states and Puerto Rico. Our high-volume upscale casual restaurants feature a global menu of contemporary American favorites, award-winning sushi and specialty cocktails. Our menu items are freshly prepared and incorporate over 40 signature sauces and dressings that we make from scratch at each restaurant location, creating broad-based appeal for the lifestyle and taste trends of a diverse group of customers. We believe that our diverse menu and generous portions, combined with an average check of approximately \$26 per person, offer our customers an attractive price-value proposition.

We plan to grow organically through unit expansion. We achieved a unit growth rate of over 20% for 2014 and 2015 and expect to achieve a similar growth rate for 2016. We opened five restaurants during the first nine months of 2016 and expect to open three restaurants during the fourth quarter of 2016, one of which was opened in October 2016, for a unit growth rate of 22%. We are adjusting our projected growth rate for 2017 below our previously targeted growth rate of 20% and believe that a more moderate growth rate will provide us the flexibility to allocate capital resources, increase our earnings and strengthen our balance sheet as well as to focus our time and attention on new restaurant operations and performance.

We continue to execute our strategy for international market franchise expansion. Given the strength our concept has enjoyed thus far in the U.S. and the increased demand for upscale casual dining concepts overseas, we believe there is a significant opportunity to expand our concept in Latin America, the Middle East and beyond through franchising. During the first half of 2016, we announced agreements for the development and franchising of six Kona Grill



restaurants in Mexico and six restaurants in the United Arab Emirates over the next seven years. We expect our first international franchised location to open during the first nine months of 2017.

Our same-store sales increased 0.7% in the third quarter of 2016 compared to a 1.6% increase in same-store sales in the third quarter of 2015. We have generated positive same-store sales in 24 of the last 25 quarters. The average unit volume of restaurant sales for our comparable base restaurants was \$1.1 million in both the third quarters of 2016 and 2015. We generated a loss from operations of \$2.4 million and \$1.4 million and net loss of \$2.6 million and \$1.5 million in the third quarter of 2016 and 2015, respectively. A significant driver of the higher net loss was due to higher operating and labor costs, in addition to higher depreciation and amortization expense attributable to new restaurant and remodeling activities.

Our restaurant operating profit, defined as restaurant sales minus cost of sales, labor, occupancy, and restaurant operating expenses, increased 7.8% to \$6.0 million in the third quarter of 2016 from \$5.6 million in the third quarter of 2015. Restaurant operating profit as a percentage of restaurant sales was 13.8% in the third quarter of 2016, and included new restaurant operating inefficiencies for 12 restaurants in the non-comparable restaurant base, five of which were opened during 2016. Restaurant operating profit as a percentage of restaurant sales was 15.4% in the third quarter of 2015, and included new restaurant operating inefficiencies for ten restaurants in the non-comparable restaurant base. Our Adjusted EBITDA, defined as income (loss) from operations plus depreciation and amortization, preopening expenses, stock-based compensation and other, was \$3.2 million and \$2.8 million in the third quarter of 2016 and 2015, respectively an increase of 13.2% from the prior year period. Adjusted EBITDA as a percentage of restaurant sales was 7.3% in the third quarter of 2016 compared to 7.8% in the third quarter of 2015, primarily attributable to higher labor costs and incremental operating costs for recently opened restaurants. See “Key Measures” and “Financial Performance Overview” below for further information on restaurant operating profit and Adjusted EBITDA, including reconciliation to our income (loss) from operations.

Our cost of sales, labor, and other operating expenses for our restaurants open at least 12 months generally trend consistently with restaurant sales, and we analyze those costs as a percentage of restaurant sales. Our typical new restaurants experience gradually increasing unit volumes as customers discover our concept and we generate market awareness. We anticipate that most of our new restaurants will take approximately six to twelve months to achieve operating efficiencies as a result of challenges typically associated with opening and operating new restaurants, including lack of market recognition and the need to hire and sufficiently train employees, as well as other factors. We expect cost of sales and labor expenses as a percentage of restaurant sales to be higher when we open a new restaurant, but to decrease as a percentage of restaurant sales as the restaurant matures and as the restaurant management and employees become more efficient in operating that unit. Occupancy and a portion of restaurant operating expenses are fixed. As a result, the volume and timing of newly opened restaurants had, and is expected to continue to have, an impact on cost of sales, labor, occupancy, and restaurant operating expenses measured as a percentage of restaurant sales which we expect will continue until these restaurants mature.

### **Key Measures We Use to Evaluate Our Company**

Key measures we use to evaluate and assess our business include the following:

*Number of Restaurant Openings.* Number of restaurant openings reflects the number of restaurants opened during a particular reporting period.

*Same-Store Sales Percentage Change.* Same-store sales percentage change reflects the periodic change in restaurant sales for the comparable restaurant base. In calculating the percentage change in same-store sales, we include a restaurant in the comparable restaurant base after it has been in operation for more than 18 months. We adjust the sales included in the same-store sales calculation for restaurant closures, primarily as a result of remodels, so that the periods will be comparable. Same-store sales growth can be generated by an increase in customer traffic counts or by increases in the per person average check amount. Menu price changes and the mix of menu items sold can affect the per person average check amount.

*Operating Weeks.* Operating weeks represent the number of weeks that our restaurants were open during the reporting period.

*Average Unit Volume.* Average unit volume represents the average restaurant sales for the comparable restaurant base.

*Restaurant Operating Profit.* Restaurant operating profit is defined as restaurant sales minus cost of sales, labor, occupancy, and restaurant operating expenses. Restaurant operating profit does not include general and administrative expenses, depreciation and amortization, or preopening expenses. We believe restaurant operating profit is an important component of financial results because it is a widely used metric within the restaurant industry to evaluate restaurant-level productivity, efficiency, and performance prior to application of corporate overhead. We use restaurant operating profit as a percentage of restaurant sales as a key metric to evaluate our restaurants' financial performance compared with our competitors. This measure provides useful information regarding our financial condition and results of operations and allows investors to better determine future financial results driven by growth and to compare restaurant level profitability.

**Adjusted EBITDA.** Adjusted EBITDA is defined as income (loss) from operations plus depreciation and amortization, preopening expenses and stock-based compensation. Adjusted EBITDA is presented because: (i) we believe it is a useful measure for investors to assess the operating performance of our business without the effect of non-cash items such as depreciation and amortization expenses and stock-based compensation as well as the costs of opening new restaurants; (ii) we believe that investors will find these measures useful in assessing our ability to service or incur indebtedness; and (iii) we use Adjusted EBITDA internally as a benchmark to evaluate our operating performance and compare our performance to that of our competitors.

## Financial Performance Overview

The following table sets forth certain information regarding our financial performance for the three and nine months ended September 30, 2016 and 2015. There were 30 and 25 restaurants in the comparable restaurant base as of September 30, 2016 and 2015, respectively.

	Three Months Ended		Nine Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Restaurant sales growth	20.7 %	19.6 %	20.0 %	19.9 %
Same-store sales percentage change <sup>(1)</sup>	0.7 %	1.6 %	2.2 %	1.6 %
Average unit volume (in thousands) <sup>(2)</sup>	\$1,129	\$1,111	\$3,463	\$3,404
Sales per square foot <sup>(2)</sup>	\$158	\$154	\$481	\$473
Restaurant operating profit (in thousands) <sup>(3)</sup>	\$5,983	\$5,550	\$19,034	\$17,614
Restaurant operating profit as a percentage of sales <sup>(3)</sup>	13.8 %	15.4 %	15.1 %	16.8 %
Adjusted EBITDA (in thousands) <sup>(4)</sup>	\$3,176	\$2,805	\$9,996	\$9,106
Adjusted EBITDA as a percentage of sales <sup>(4)</sup>	7.3 %	7.8 %	7.9 %	8.7 %

Same-store sales percentage change reflects the periodic change in restaurant sales for the comparable restaurant base compared to the prior year. In calculating the percentage change for same-store sales, we include a restaurant <sup>(1)</sup> in the comparable restaurant base after it has been in operation for more than 18 months. We remove restaurants from the comparable base for periods in which they are closed, primarily related to remodel activities.

<sup>(2)</sup>Includes only those restaurants in the comparable restaurant base.

<sup>(3)</sup>Restaurant operating profit is not a financial measurement determined in accordance with U.S. generally accepted accounting principles (see reconciliation below) and should not be considered in isolation or as an alternative to income from operations. Restaurant operating profit may not be comparable to the same or similarly titled measures computed by other companies. We believe restaurant operating profit is an important component of financial results because it is a widely used metric within the restaurant industry to evaluate restaurant-level productivity, efficiency, and performance. We use restaurant operating profit as a percentage of restaurant sales as

a key metric to evaluate our restaurants' financial performance compared with our competitors.

Adjusted EBITDA is not a financial measure determined in accordance with U.S. generally accepted accounting principles (see reconciliation below) and should not be considered in isolation or as an alternative to income from operations. Adjusted EBITDA is defined as income from operations plus depreciation and amortization, preopening expense, stock-based compensation and unusual or non-recurring items. Adjusted EBITDA is presented because: (i) we believe it is a useful measure for investors to assess the operating performance of our business without the effect of non-cash items such as depreciation and amortization expenses and stock-based compensation as well as the costs of opening new restaurants; (ii) we believe that investors will find these measures useful in assessing our ability to service or incur indebtedness; and (iii) we use Adjusted EBITDA internally as a benchmark to evaluate our operating performance and compare our performance to that of our competitors.

The following tables set forth our reconciliation of Adjusted EBITDA and restaurant operating profit to our income (loss) from operations, the most comparable U.S. GAAP measure.

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
	<b>(In thousands)</b>			
Income (loss) from operations	\$ (2,411)	\$ (1,401)	\$ (4,727 )	\$ (2,321 )
Depreciation and amortization	3,837	2,471	10,338	6,945
Preopening expenses	1,430	1,379	3,443	3,302
Stock-based compensation	320	356	942	1,019
Other expenses	—	—	—	161
Adjusted EBITDA	\$3,176	\$2,805	\$9,996	\$9,106
General and administrative	3,127	3,101	9,980	9,527
Stock-based compensation	(320 )	(356 )	(942 )	(1,019 )
Restaurant operating profit	\$5,983	\$5,550	\$19,034	\$17,614

	<b>Percentage of Restaurant Sales</b>		<b>Percentage of Restaurant Sales</b>	
	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September</b>		<b>September</b>	
	<b>30,</b>	<b>2015</b>	<b>30,</b>	<b>2015</b>
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
Income (loss) from operations	(5.6 )%	(3.9 )%	(3.7 )%	(2.2 )%
Depreciation and amortization	8.8	6.9	8.2	6.6
Preopening expenses	3.3	3.8	2.7	3.1
Stock-based compensation	0.7	1.0	0.7	1.0
Other expenses	—	—	—	0.2
Adjusted EBITDA	7.3	7.8	7.9	8.7
General and administrative	7.2	8.6	7.9	9.1
Stock-based compensation	(0.7 )	(1.0 )	(0.7 )	(1.0 )

Restaurant operating profit      13.8%   15.4%   15.1%   16.8%

Certain amounts may not sum due to rounding.

**Results of Operations**

The following tables set forth, for the periods indicated, certain items from our financial statements and the percentage of restaurant sales for those items:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30, 2016</b>	<b>2015</b>	<b>September 30, 2016</b>	<b>2015</b>
Restaurant sales	\$43,358	\$35,925	\$125,931	\$104,957
Costs and expenses:				
Cost of sales	11,602	9,812	33,316	28,552
Labor	16,005	12,687	45,602	36,471
Occupancy	3,499	2,638	10,006	7,496
Restaurant operating expenses	6,269	5,238	17,973	14,824
General and administrative	3,127	3,101	9,980	9,527
Preopening expenses	1,430	1,379	3,443	3,302
Depreciation and amortization	3,837	2,471	10,338	6,945
Other expenses	-	-	-	161
Total costs and expenses	45,769	37,326	130,658	107,278
Income (loss) from operations	(2,411 )	(1,401 )	(4,727 )	(2,321 )
Interest expense, net	138	42	263	133
Income (loss) before income taxes	(2,549 )	(1,443 )	(4,990 )	(2,454 )
Income tax expense	6	25	56	32
Net income (loss)	\$(2,555 )	\$(1,468 )	\$(5,046 )	\$(2,486 )

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30, 2016</b>	<b>2015</b>	<b>September 30, 2016</b>	<b>2015</b>
Restaurant sales	100.0%	100.0%	100.0%	100.0%
Costs and expenses:				
Cost of sales	26.8	27.3	26.5	27.2
Labor	36.9	35.3	36.2	34.7
Occupancy	8.1	7.3	7.9	7.1
Restaurant operating expenses	14.5	14.6	14.3	14.1
General and administrative	7.2	8.6	7.9	9.1
Preopening expenses	3.3	3.8	2.7	3.1
Depreciation and amortization	8.8	6.9	8.2	6.6



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Other expenses	0.0	0.0	0.0	0.2
Total costs and expenses	105.6	103.9	103.7	102.2
Income (loss) from operations	(5.6 )	(3.9 )	(3.7 )	(2.2 )
Interest expense, net	0.3	0.1	0.2	0.1
Income (loss) before income taxes	(5.9 )	(4.0 )	(4.0 )	(2.3 )
Income tax expense	0.0	0.1	0.0	0.0
Net income (loss)	(5.9 )%	(4.1 )%	(4.0 )%	(2.4 )%

Certain amounts may not sum due to rounding.

***Three Months Ended September 30, 2016 Compared with Three Months Ended September 30, 2015***

*Restaurant Sales.* Restaurant sales increased \$7.4 million, or 20.7%, to \$43.4 million during the third quarter of 2016 from \$35.9 million in the third quarter of 2015, primarily attributable to a 26.4% increase in the number of operating weeks from nine restaurants opened since the fourth quarter of 2015. Same-store sales increased 0.7% year-over-year, driven primarily by average check growth resulting from menu price increases in October 2015 and March 2016 and favorable menu mix, partially offset by a slight decrease in customer traffic. The 0.7% same-store sales growth in the third quarter of 2016 compares to a 1.6% increase in same-store sales in the third quarter of 2015.

*Cost of Sales.* Cost of sales increased \$1.8 million, or 18.2% to \$11.6 million in the third quarter of 2016 compared to \$9.8 million in the same prior year period. The increase is primarily attributable to nine new locations opened since the fourth quarter of 2015. As a percentage of restaurant sales, cost of sales was 26.8% compared to 27.3% in the prior year quarter, primarily reflecting leverage on purchasing initiatives and favorable commodity pricing on poultry, produce and dairy products compared to last year.

*Labor.* Labor costs increased \$3.3 million, or 26.2%, to \$16.0 million during the third quarter of 2016 compared to \$12.7 million during the prior year period. The increase is primarily attributable to nine new locations opened since the fourth quarter of 2015. Labor expenses as a percentage of restaurant sales increased to 36.9% compared to 35.3% in the prior year period, reflecting labor inefficiencies from our newly opened locations and wage inflation across many markets in which we operate. We expect labor costs as a percentage of sales to typically trend higher upon opening and gradually improve as our new restaurant management teams become more efficient in operating their restaurants. However, this expectation will continue to be impacted by wage inflation and changes in minimum wage and overtime laws.

*Occupancy.* Occupancy expenses increased \$0.9 million or 32.7% to \$3.5 million in the third quarter of 2016 from \$2.6 million in the prior year period, primarily associated with base rent, common area maintenance charges and real estate taxes for nine new locations opened since the fourth quarter of 2015. Occupancy expenses as a percentage of restaurant sales were 8.1% in the third quarter of 2016 compared to 7.3% in the third quarter of 2015.

*Restaurant Operating Expenses.* Restaurant operating expenses increased \$1.1 million, or 19.7%, to \$6.3 million in the third quarter of 2016 compared to \$5.2 million in the third quarter of 2015, primarily due to the additional operating expenses for nine new restaurants opened since the fourth quarter of 2015. Restaurant operating expenses as a percentage of restaurant sales were 14.5% and 14.6% in the third quarter of 2016 and 2015, respectively.

*General and Administrative.* General and administrative expenses were \$3.1 million in both the third quarter of 2016 and 2015. As a percentage of sales, general and administrative expenses decreased 140 basis points to 7.2% in the

third quarter of 2016 compared to 8.6% in the prior year period, primarily reflecting leverage on higher sales volume and lower incentive compensation.

*Preopening Expenses.* Preopening expense of \$1.4 million in the third quarter of 2016 was primarily attributable to two restaurant openings during the third quarter and training, non-cash rent and other costs associated with three restaurants scheduled to open in the fourth quarter of 2016. Preopening expense of \$1.4 million in the third quarter of 2015 was primarily attributable to training, non-cash rent and other costs for four restaurants that opened in the fourth of 2015.

*Depreciation and Amortization.* Depreciation and amortization expense increased \$1.4 million, or 55.3%, to \$3.8 million from \$2.5 million in the prior year period. Depreciation and amortization expense as a percentage of restaurant sales was 8.8% and 6.9% of restaurant sales in the third quarter of 2016 and 2015, respectively. The increase was primarily attributable to nine new restaurants opened since the beginning of the fourth quarter of 2015 and depreciation expense for two restaurants that were remodeled during the past twelve months.

*Interest Expense, Net.* Net interest expense is attributable to the amortization of deferred loan fees, the commitment fees associated with the KeyBank credit facility and interest incurred on borrowings under the credit facility partially offset by interest income earned from cash and cash equivalents and investment balances. Interest expense was higher compared to the prior year period as we had higher borrowings under the credit facility during the three months ended September 30, 2016, primarily to fund new restaurant construction and our stock repurchase program.

*Income Tax Expense.* Income tax expense was \$6,000 and \$25,000 for the three months ended September 30, 2016 and 2015, respectively, and consisted of state income tax expenses for which no net operating loss carryforwards or other credits exist.

### ***Nine Months Ended September 30, 2016 Compared with Nine Months Ended September 30, 2015***

*Restaurant Sales.* Restaurant sales increased 20.0% to \$125.9 million for the nine months ended September 30, 2016 from \$105.0 million in the prior year period, primarily due to a 23.8% increase in the number of operating weeks from 12 restaurants opened since the beginning of 2015 and same-store sales growth of 2.2%. The 2.2% same-store sales growth in the first nine months of 2016 compares to a 1.6% increase in same-store sales in the first nine months of 2015.

*Cost of Sales.* Cost of sales increased \$4.8 million, or 16.7% to \$33.3 million for the nine months ended September 30, 2016 compared to \$28.6 million during the same period in the prior year, primarily attributable to 12 new locations that opened since the beginning of 2015. As a percentage of restaurant sales, cost of sales was 26.5% compared to 27.2% during the prior year period, primarily reflecting favorable commodity pricing for poultry, produce and dairy products and purchasing leverage associated with our larger base of restaurants.

*Labor.* Labor costs for the nine months ended September 30, 2016 increased \$9.1 million, or 25.0% to \$45.6 million compared to \$36.5 million in the prior year period, mainly due to incremental labor costs for 12 new locations opened since the beginning of 2015. Labor expenses as a percentage of restaurant sales increased to 36.2% compared to 34.7% in the prior year period driven mainly by inefficiencies associated with our newer restaurants as well as higher wages and increased training costs associated with a tight labor market and changes in state minimum wage laws.

*Occupancy.* Occupancy expenses increased \$2.5 million or 33.5% to \$10.0 million in the first nine months of 2016 compared to \$7.5 million in the prior year period. Higher base rent and common area maintenance charges associated with 12 locations opened since the beginning of 2015 accounted for the majority of the total year-over-year increase. Occupancy expenses as a percentage of restaurant sales were 7.9% in year-to-date 2016 compared to 7.1% in the same prior year period.

*Restaurant Operating Expenses.* Restaurant operating expenses increased \$3.1 million, or 21.2%, to \$18.0 million during the first nine months of 2016 compared to \$14.8 million in the prior year period, primarily due to incremental operating expenses associated with 12 new restaurants opened since the beginning of 2015. Restaurant operating expenses as a percentage of restaurant sales were 14.3% for the nine months ended September 30, 2016 compared to 14.1% in for the nine months ended September 30, 2015. The year-over-year increase was driven primarily by higher training-related travel costs, repair and maintenance, professional service fees and personal property taxes.

*General and Administrative.* General and administrative expenses increased by \$0.5 million, or 4.8% to \$10.0 million from \$9.5 million year-over-year. Increased payroll and benefit costs to support our unit growth expansion and higher legal and professional fees associated with the signing of two international development agreements contributed to the year-over-year increase in absolute dollars. General and administrative expenses as a percentage of sales decreased to 7.9% for the nine months ended September 30, 2016 compared to 9.1% in the prior year period reflecting leverage on a higher sales base.

*Preopening Expenses.* Preopening expenses were \$3.4 million and \$3.3 million for the nine months ended September 30, 2016 and 2015, respectively. Preopening expenses in year-to-date 2016 were primarily attributable to five restaurants opened during the first nine months of 2016 and three restaurants scheduled to open during the fourth quarter of 2016. Preopening expenses for the nine months ended September 30, 2015 were primarily attributable to three restaurants opened during the first nine months of 2015 and four restaurants that opened during the fourth quarter of 2015.

*Depreciation and Amortization.* Depreciation and amortization expense increased \$3.4 million or 48.9% to \$10.3 million year-over-year, primarily attributable to 12 new restaurants opened since the beginning of 2015 and two remodeled restaurants. Depreciation and amortization expense as a percentage of restaurant sales was 8.2% and 6.6% of restaurant sales in the first nine months of 2016 and 2015, respectively.

*Other Expenses.* Other expenses of \$0.2 million in the first nine months of 2015 primarily related to an expected settlement of a state use tax audit.

*Interest Expense, Net.* Interest expense increased year-over-year due to borrowings under the credit facility. We used the majority of the borrowings to fund new restaurant construction and remodel activities and our stock repurchase program during the first nine months of 2016. We did not borrow from the credit facility in the first nine months of 2015.

*Income Tax Expense.* We recorded income tax expense of \$56,000 and \$32,000 for the nine months ended September 30, 2016 and 2015, respectively. Income tax expense during the first nine months of 2016 consists of state tax expenses for which no state net operating loss carryforwards and other credits exist. Income tax expense for the nine months ended September 30, 2015 relates to state income tax expense for which no net operating loss carryforwards or other credits exist partially offset by refunds primarily associated with previous year state income tax.

### **Potential Fluctuations in Quarterly Results and Seasonality**

Our quarterly operating results may fluctuate significantly as a result of a variety of factors, including the following:

- timing of new restaurant openings and related expenses;
- fluctuations in commodity and food protein prices;
- preopening costs for our newly-opened restaurants and operating costs for those locations, which are often materially greater during the first several months of operation than thereafter;
- timing of restaurant remodels and potential lost sales associated with remodel closure;
- labor availability and wages and benefits for hourly and management personnel;
- profitability of our restaurants, especially in new markets;
- increases and decreases in comparable restaurant sales;
- impairment of long-lived assets and any loss on restaurant closures;
- changes in borrowings and interest rates;
- general economic conditions;
- weather conditions or natural disasters;

timing of certain holidays;  
changes in government regulations;  
settlements, damages and legal costs associated with litigation;  
new or revised regulatory requirements and accounting pronouncements; and  
changes in consumer preferences and competitive conditions.

Our business is also subject to seasonal fluctuations. Historically, sales in most of our restaurants have been higher during the spring and summer months and winter holiday season. Consequently, our quarterly and annual operating results and comparable restaurant sales may fluctuate significantly as a result of seasonality and the factors discussed above. Accordingly, results for any one quarter are not necessarily indicative of results to be expected for any other quarter or for any year and comparable restaurant sales for any particular future period may decrease. In the future, operating results may fall below the expectations of our investors. In that event, the price of our common stock would likely be impacted.

## Liquidity and Capital Resources

Currently, our primary ongoing capital requirements are for new restaurant development and remodeling of existing restaurants. Similar to many restaurant companies, we utilize operating lease arrangements for all of our restaurant locations. We believe that our operating lease arrangements provide appropriate leverage for our capital structure in a financially efficient manner. We are typically required to expend cash for leasehold improvements, furniture, fixtures and equipment to construct and equip each restaurant. We also require capital resources to maintain our existing base of restaurants, including remodeling, to further expand and strengthen the capabilities of our corporate and information technology infrastructures and for approved stock repurchase programs.

The following tables set forth, as of the dates and for the periods indicated, a summary of our key liquidity measurements (amounts in thousands):

	<b>September 30, 2016</b>	<b>December 31, 2015</b>
Cash and short-term investments	\$ 6,321	\$ 9,233
Net working capital deficit	\$ (6,569 )	\$ (5,384 )

	<b>Nine Months Ended September 30, 2016    2015</b>	
Cash provided by operating activities	\$ 14,474	\$ 6,796
Capital expenditures	\$ 32,659	\$ 28,062

### *Future Capital Requirements*

Our capital requirements, including development costs related to the opening of new restaurants, have historically been significant. Over the past year, we funded development of new restaurants and remodels primarily from cash flows from operations, funds raised in our 2014 public offering of stock and borrowings under our credit facility. Our future cash requirements and the adequacy of available funds will depend on many factors, including the operating performance of our current restaurants, the pace of expansion and remodels, real estate markets, site locations, the nature of the arrangements negotiated with landlords and capital market accessibility.



We plan to grow organically through unit expansion. We opened five restaurants during the first nine months of 2016 and expect to open three additional restaurants during the fourth quarter of 2016 for a unit growth rate of 22%. We expect to spend approximately \$32 million to \$34 million in capital expenditures in 2016, net of tenant improvement allowances, for the planned construction and remodel of our restaurants. We are adjusting our projected growth rate for 2017 below our previously targeted growth rate of 20% and believe that a more moderate growth rate will provide us the flexibility to allocate our capital resources, to increase our earnings and to strengthen our balance sheet as well as to focus our time and attention on new restaurant operations and performance.

As of September 30, 2016, we had a working capital deficit of \$6.6 million and borrowings under our credit facility of \$25 million. We believe existing cash and cash equivalents and short-term investments of \$6.3 million, the ability to draw additional borrowings under our recently amended \$60 million credit facility, subject to compliance with certain covenants, and cash flow from operations will be sufficient to fund property additions for new restaurants and planned remodels of existing restaurants during 2016.

During the first half of 2016, we repurchased \$9.8 million of common stock and completed our \$10 million stock repurchase program in June 2016.

Any reduction of our cash flow from operations or an inability to draw on our credit facility may cause a delay or cancellation of future restaurant development or remodels of existing restaurants. Financing to construct new restaurants or remodels for amounts in excess of our current cash and short-term investments and the line of credit availability may not be available on acceptable terms, or at all, and our failure to raise capital when needed could impact our growth plans, financial condition, and results of operations. Additional equity financing, to the extent available, may result in dilution to current stockholders and debt financing, if available, may involve significant cash payment obligations or financial covenants and ratios that may restrict our ability to operate our business.

### ***Debt and Credit Agreements***

On April 19, 2013, we entered into a Credit Agreement for a \$20 million revolving line of credit maturing on April 19, 2017 with KeyBank National Association (“KeyBank”) and Stearns Bank National Association (“Stearns Bank”). On November 7, 2014, we entered into an Amended and Restated Credit Agreement (the “Amended Credit Agreement”) with KeyBank to (i) increase the credit facility from \$20 million to \$35 million, and (ii) extend the maturity date of the credit facility to November 7, 2019. On October 12, 2016, we entered into the Second Amended and Restated Credit Agreement (the “Second Amended Credit Agreement”) with KeyBank and Zions First National Bank to (i) increase the credit facility from \$35 million to \$60 million, comprised of a \$45 million revolver (“Revolver”) and \$15 million term loan (“Term Loan”), and (ii) extend the maturity date of the credit facility to October 12, 2021. The credit facility is secured by our personal property and assets. Certain of our wholly owned subsidiaries have also guaranteed the credit facility. See “Subsequent Events” in Note 11 of the Notes to the Condensed Consolidated Financial Statements.

The interest rate under the Second Amended Credit Agreement is KeyBank’s prime rate or LIBOR, at our option, plus an applicable margin depending on our leverage ratio. The LIBOR margins range from 1.75% to 2.75% and the base rate margins range from 0.75% to 1.75%. Payments on the Term Loan are due quarterly and subject to acceleration upon certain events as defined in the Second Amended Credit Agreement, while borrowings on the Revolver are interest only, payable quarterly with respect to each base rate loan and at varying times with respect to LIBOR rate loans, with outstanding principal and interest due at maturity. Prepayment is permitted at any time without penalty, subject to certain restrictions on the order of repayment or prepayment. We are obligated to pay a commitment fee at an annual rate of 0.175% to 0.350%, depending on our leverage ratio, times the unused total revolving commitment of the credit facility based on the average daily amount outstanding under the credit facility for the previous quarter. The commitment fee is payable quarterly in arrears.

The credit facility also requires us to comply with certain covenants, including (a) a fixed charge coverage ratio of not less than 1.50 and (b) a maximum leverage ratio of 4.25 to 1.0 through the maturity date. We may from time to time request that the total revolving credit commitment under the Second Amended Credit Agreement be increased up to an amount not to exceed \$85 million. Any such increase is subject to agreement of the respective lenders in the lending syndicate or new lenders in certain circumstances. Any such increase, which may be for a lesser amount than requested by us, is also subject to certain other terms and conditions as provided in the Second Amended Credit Agreement. See “Debt and Credit Agreements” in Note 6 of the Notes to the Condensed Consolidated Financial Statements for further discussion on our debt and credit agreements.

### ***Cash Flows***

The following table summarizes our primary sources and uses of cash during the periods presented (in thousands):

	<b>Nine Months Ended September 30,</b>	
	<b>2016</b>	<b>2015</b>
Net cash provided by (used in):		
Operating activities	\$14,474	\$6,796
Investing activities	(32,747)	(28,145)
Financing activities	15,361	554
Net change in cash and cash equivalents	\$(2,912 )	\$(20,795)

*Operating Activities.* Our cash flows from operating activities provided \$14.5 million and \$6.8 million of net cash during the first nine months of 2016 and 2015, respectively. The year-over-year change in cash from operating activities is primarily due to timing of receipt of tenant allowance reimbursements and timing of payments for accounts payable and accrued expenses during the first nine months of 2016 compared to the same period in 2015.

*Investing Activities.* Capital expenditures for the nine months ended September 30, 2016 were \$32.7 million, primarily attributed to costs associated with five restaurants opened during the year, costs for our Las Vegas restaurant remodel, residual payments from restaurants opened during the fourth quarter of 2015 as well as construction and architecture and design costs associated with planned new restaurant openings for the remainder of 2016 and first half of 2017. Capital expenditures for the nine months ended September 30, 2015 were \$28.1 million, primarily associated with our San Juan, Plano and Arlington restaurants opened during the first nine months of 2015, our Denver remodel and architecture, design and construction-related costs associated with four new restaurants that opened in the fourth quarter of 2015.

*Financing Activities.* Net cash provided by financing activities for the nine months ended September 30, 2016 consisted of \$25.0 million of borrowings under our credit facility and \$0.1 million of net proceeds from stock option exercises, partially offset by \$9.8 million in cash outflows for the repurchase of our common stock. Net cash provided by financing activities for the nine months ended September 30, 2015 consisted primarily of proceeds from stock option exercises.

### **Off-Balance Sheet Arrangements**

As of September 30, 2016, we had no off-balance sheet arrangements or obligations.

### **Critical Accounting Policies and Estimates**

Critical accounting policies and estimates are those that we believe are both significant and that require us to make difficult, subjective or complex judgments, often because we need to estimate the effect of inherently uncertain matters. We base our estimates and judgments on historical experiences and various other factors that we believe to be appropriate under the circumstances. Actual results may differ from these estimates, and we might obtain different estimates if we used different assumptions or conditions. We had no significant changes in our critical accounting policies and estimates since our last annual report. Our critical accounting policies and estimates are identified and described in our annual report on Form 10-K for the year ended December 31, 2015.

### **Item 3. *Quantitative and Qualitative Disclosures About Market Risk***

#### ***Commodity Price Risk***

Our primary market risk exposure is commodity costs. Many of the food products purchased by us can be subject to volatility due to changes in weather, production, availability, seasonality, international demand, and other factors outside our control. Substantially all of our food and supplies are available from several sources, which help to diversify our overall commodity cost risk. We also believe that we have the ability to increase certain menu prices in response to food commodity price increases.

### *Inflation*

The primary inflationary factors affecting our operations are food, labor costs, energy costs and labor and materials used in the construction of new restaurants. Increases in minimum wages could directly affect our labor costs. Many of our leases require us to pay taxes, maintenance, repairs, insurance, and utilities, all of which are generally subject to inflationary adjustments. These increases could impact our operating results to the extent that such increases cannot be passed along through higher menu prices. Over the past five years, inflation has not significantly affected our operating results.

***Interest Rate Risk***

We may also face market risk exposure due to the variable interest rates on the credit line obtained from KeyBank. Interest on the loans is subject to adjustment based on changes to the Prime or LIBOR rates. Interest rate fluctuations may adversely impact our financial condition or results of operations.

**Item 4. *Controls and Procedures***

***Evaluation of Disclosure Controls and Procedures***

We maintain disclosure controls and procedures (as defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) that are designed to ensure that information required to be disclosed in Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

As of September 30, 2016, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

There were no changes during the three months ended September 30, 2016 in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

**PART II - OTHER INFORMATION**

**Item 1. *Legal Proceedings***

See “Commitments and Contingencies” in Note 10 of the Notes to the Condensed Consolidated Financial Statements for a description of our material legal proceedings.

**Item 1A. Risk Factors**

There have been no material changes in our risk factors since our annual report on Form 10-K for the year ended December 31, 2015. A description of the risk factors associated with our business is contained in Part I, Item 1A, “Risk Factors,” in our Annual Report on Form 10-K for the year ended December 31, 2015. These cautionary statements are to be used as a reference in connection with any forward-looking statements. The factors, risks, and uncertainties identified in these cautionary statements are in addition to those contained in any other cautionary statements, written or oral, which may be made or otherwise addressed in connection with a forward-looking statement or contained in any of our subsequent filings with the SEC.

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

Not applicable.

**Item 3. Defaults Upon Senior Securities**

Not applicable.

**Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information**

Not applicable.

**Item 6. Exhibits**

<b><u>Exhibit Number</u></b>	<b><u>Exhibit</u></b>
3.1	Certificate of Designation, Preferences, and Rights of Series B Junior Participating Preferred Stock of Kona Grill, Inc. filed with the Secretary of State of the State of Delaware on September 7, 2016 (incorporated by reference from Form 8-K filed September 7, 2016)
4.1	Rights Agreement dated September 6, 2016 by and between Kona Grill, Inc. and Continental Stock Transfer & Trust Company (incorporated by reference from Form 8-K filed September 7, 2016)
10.1	Second Amended and Restated Credit Agreement dated as of October 12, 2016 (incorporated by reference from



10.2 Form 8-K filed  
October 18, 2016)  
Amended and  
Restated Pledge  
and Security  
Agreement dated as  
of October 12,  
2016 (incorporated  
by reference from  
Form 8-K filed  
October 18, 2016)

10.3 Amended and  
Restated Subsidiary  
Guaranty dated as  
of October 12,  
2016 (incorporated  
by reference from  
Form 8-K filed  
October 18, 2016)

31.1 Certification of  
Chief Executive  
Officer pursuant to  
Rule 13a-14(a) and  
Rule 15d-14(a),  
promulgated under  
the Securities  
Exchange Act of  
1934, as amended.

31.2 Certification of  
Chief Financial  
Officer pursuant to  
Rule 13a-14(a) and  
Rule 15d-14(a),  
promulgated under  
the Securities  
Exchange Act of  
1934, as amended.

32.1 Certification  
pursuant to 18  
U.S.C. Section  
1350, as adopted  
pursuant to Section  
906 of the  
Sarbanes-Oxley  
Act of 2002.

32.2 Certification  
pursuant to 18  
U.S.C. Section  
1350, as adopted

101 pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. Interactive data files pursuant to Rule 405 of Regulation S-T (i) the Condensed Consolidated Balance Sheets as of September 30, 2016 and December 31, 2015, (ii) the Unaudited Condensed Consolidated Statements of Comprehensive Income (Loss) for the three and nine months ended September 30, 2016 and 2015, (iii) the Unaudited Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2016 and 2015 and (iv) the Notes to the Unaudited Condensed Consolidated Financial Statements.

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**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 thereunto duly authorized.

**Kona Grill, Inc.**

/s/ Berke Bakay  
Berke Bakay  
*President, Chief Executive Officer and Director*

*(Principal Executive Officer)*

/s/ Christi Hing  
Christi Hing  
*Chief Financial Officer*

*(Principal Accounting and Financial Officer)*

Date: November 1, 2016