

KONA GRILL INC
Form 10-Q
November 10, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2011

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

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

Delaware
(State or other jurisdiction of incorporation or organization)

20-0216690
(I.R.S. Employer Identification No.)

7150 East Camelback Road, Suite 220
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

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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 | <input type="radio"/> | Accelerated filer | <input type="radio"/> |
| Non-accelerated filer | <input type="radio"/> (Do not check if a smaller reporting company) | Smaller reporting company | <input checked="" type="radio"/> |

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, 2011, there were 9,378,896 shares of the registrant’s common stock outstanding.

KONA GRILL, INC.

TABLE OF CONTENTS

| | Page |
|---|------|
| PART I. FINANCIAL INFORMATION | |
| Item 1. Consolidated Financial Statements | |
| Consolidated Balance Sheets as of September 30, 2011 (Unaudited) and December 31, 2010 | 2 |
| Unaudited Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2011 and 2010 | 3 |
| Unaudited Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2011 and 2010 | 4 |
| Notes to Unaudited Consolidated Financial Statements | 5 |
| Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations | 9 |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk | 18 |
| Item 4. Controls and Procedures | 19 |
| PART II. OTHER INFORMATION | |
| Item 1. Legal Proceedings | 19 |
| Item 1A. Risk Factors | 20 |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds | 20 |
| Item 3. Defaults Upon Senior Securities | 20 |
| Item 4. (Removed and Reserved) | 20 |
| Item 5. Other Information | 20 |
| Item 6. Exhibits | 20 |

PART I – FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

KONA GRILL, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

| | September 30, 2011 (Unaudited) | December 31, 2010 (Note 1) |
|---|--------------------------------------|----------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$5,843 | \$2,555 |
| Investments | 175 | 174 |
| Receivables | 5 | 10 |
| Other current assets | 1,239 | 1,212 |
| Total current assets | 7,262 | 3,951 |
| Other assets | 708 | 650 |
| Property and equipment, net | 33,800 | 37,459 |
| Total assets | \$41,770 | \$42,060 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$1,675 | \$2,279 |
| Accrued expenses | 6,548 | 6,046 |
| Current portion of notes payable | 219 | 504 |
| Total current liabilities | 8,442 | 8,829 |
| Notes payable | — | 132 |
| Deferred rent | 14,160 | 16,110 |
| Total liabilities | 22,602 | 25,071 |
| Commitments and contingencies (Note 9) | | |
| Stockholders' equity: | | |
| Preferred stock, \$0.01 par value, 2,000,000 shares authorized, none issued | — | — |
| Common stock, \$0.01 par value, 15,000,000 shares authorized, 9,495,096 shares issued and 9,378,896 shares outstanding at September 30, 2011; 9,302,995 shares issued and 9,186,795 shares outstanding at December 31, 2010 | 95 | 93 |
| Additional paid-in capital | 59,129 | 58,232 |
| Accumulated deficit | (39,056) | (40,336) |
| Treasury stock, at cost, 116,200 shares at September 30, 2011 and December 31, 2010 | (1,000) | (1,000) |
| Total stockholders' equity | 19,168 | 16,989 |
| Total liabilities and stockholders' equity | \$41,770 | \$42,060 |

See accompanying notes to the unaudited consolidated financial statements.

KONA GRILL, INC.
 UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS
 (in thousands, except per share data)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|-----------|------------------------------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| Restaurant sales | \$23,838 | \$20,560 | \$70,591 | \$61,614 |
| Costs and expenses: | | | | |
| Cost of sales | 6,372 | 5,623 | 19,251 | 16,430 |
| Labor | 7,815 | 7,081 | 23,365 | 21,367 |
| Occupancy | 1,742 | 1,634 | 5,125 | 4,888 |
| Restaurant operating expenses | 3,538 | 3,315 | 10,627 | 9,565 |
| General and administrative | 2,117 | 1,446 | 6,147 | 5,456 |
| Preopening expense | — | 382 | — | 509 |
| Depreciation and amortization | 1,474 | 1,371 | 4,419 | 4,138 |
| Total costs and expenses | 23,058 | 20,852 | 68,934 | 62,353 |
| Income (loss) from operations | 780 | (292) | 1,657 | (739) |
| Nonoperating income (expense): | | | | |
| Interest income and other, net | — | — | 2 | 51 |
| Interest expense | (26) | (4) | (47) | (119) |
| Income (loss) from continuing operations before provision for income taxes | 754 | (296) | 1,612 | (807) |
| Provision for income taxes | 19 | — | 44 | 10 |
| Income (loss) from continuing operations | 735 | (296) | 1,568 | (817) |
| Loss from discontinued operations, net of tax | (146) | (145) | (288) | (269) |
| Net income (loss) | \$589 | \$(441) | \$1,280 | \$(1,086) |
| Net income (loss) per share – Basic and Diluted: | | | | |
| Income (loss) from continuing operations | \$0.08 | \$(0.03) | \$0.17 | \$(0.09) |
| Loss from discontinued operations, net of tax | (0.02) | (0.02) | (0.03) | (0.03) |
| Net income (loss) | \$0.06 | \$(0.05) | \$0.14 | \$(0.12) |
| Weighted average shares used in computation: | | | | |
| Basic | 9,256 | 9,168 | 9,224 | 9,163 |
| Diluted | 9,454 | 9,168 | 9,398 | 9,163 |

See accompanying notes to the unaudited consolidated financial statements.

KONA GRILL, INC.
 UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
 (in thousands)

| | Nine Months Ended September 30, | |
|--|------------------------------------|------------|
| | 2011 | 2010 |
| Operating activities | | |
| Net income (loss) | \$1,280 | \$(1,086) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Depreciation and amortization | 4,454 | 4,178 |
| Stock-based compensation expense | 357 | 329 |
| Loss on disposal of assets | 108 | — |
| Change in operating assets and liabilities: | | |
| Receivables | 5 | 174 |
| Other current assets | (27) | (45) |
| Accounts payable | (354) | (615) |
| Accrued expenses | 502 | 90 |
| Deferred rent | (1,950) | 205 |
| Net cash provided by operating activities | 4,375 | 3,230 |
| Investing activities | | |
| Purchase of property and equipment | (1,153) | (3,478) |
| (Increase) decrease in other assets | (58) | 15 |
| Net purchases and sales of investments | (1) | 6,108 |
| Net cash (used in) provided by investing activities | (1,212) | 2,645 |
| Financing activities | | |
| Repayments on line of credit | — | (5,800) |
| Repayments of notes payable | (417) | (531) |
| Proceeds from issuance of common stock under the Employee Stock Purchase Plan and exercise of stock options and warrants | | |
| | 542 | 63 |
| Net cash provided by (used in) financing activities | 125 | (6,268) |
| Net increase (decrease) in cash and cash equivalents | 3,288 | (393) |
| Cash and cash equivalents at the beginning of the period | 2,555 | 2,404 |
| Cash and cash equivalents at the end of the period | \$5,843 | \$2,011 |
| Supplemental disclosure of cash flow information | | |
| Cash paid for interest, net of capitalization | \$27 | \$79 |
| Noncash investing activities | | |
| Decrease in accounts payable related to property and equipment | \$(250) | \$(208) |

See accompanying notes to the unaudited consolidated financial statements.

KONA GRILL, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation

Kona Grill, Inc. (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 diverse selection of mainstream American dishes and award-winning sushi that are prepared fresh daily. We own and operate 23 restaurants in 16 states throughout the United States.

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles 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 footnotes required by U.S. generally accepted accounting principles 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, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011.

The consolidated balance sheet at December 31, 2010 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by U.S. generally accepted accounting principles 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, 2010.

2. Advertising and Marketing Costs

Advertising and marketing costs are expensed as incurred. We maintain a guest loyalty club (the Konavore™ program), an email-based marketing program designed to communicate new menu offerings, restaurant specific events, and other marketing messages to keep Kona Grill top of mind for consumers. The Konavore™ loyalty program offers members a discount coupon upon enrolling in the program and a discount coupon for a member’s birthday. These coupons are recognized upon redemption and recorded in the financial statements as a sales discount. Costs associated with the redemption of a promotion in the form of a coupon for discounted product are recorded in cost of sales as these coupons are typically redeemed with purchase of additional food and beverage items. Costs associated with promotional giveaways of food and beverages to local businesses and sponsorship of events are viewed as advertising in nature and recorded in restaurant operating expenses.

3. Discontinued Operations

As part of ongoing profitability initiatives, we closed our West Palm Beach, Florida and Sugar Land, Texas restaurants during the third quarter of 2011. The decision to close these restaurants was based on these restaurants’ past and present operating performance and projected future results. We entered into an amendment with the landlord of the West Palm Beach restaurant that provided for the early termination of the lease on July 31, 2011. Under the lease amendment, we paid an early termination fee and agreed not to remove certain restaurant equipment from the premises. We closed the Sugar Land location on September 21, 2011.

During the third quarter of 2011, we recognized \$1,050,000 related to estimated and actual lease termination costs for the two restaurants closed during the quarter and \$211,000 for severance, relocation, and other exit costs. The lease termination and exit cost accrual is included in accrued expenses on the consolidated balance sheets. These costs are partially offset by deferred rent write-offs of \$1,260,000. We also recognized \$53,000 in non-cash asset impairment charges related to the write-off of equipment and furniture left at the closed restaurants. We previously recognized

non-cash asset impairment charges of \$5,204,000 associated with these restaurants during 2009.

We determined that the closures met the criteria for classification as discontinued operations as of September 30, 2011. As a result, all historical operating results as well as lease termination and exit costs attributable to these restaurants are reflected within discontinued operations in the consolidated statements of operations for all periods presented. Loss from discontinued operations, net of tax is comprised of the following (in thousands):

5

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|----------|------------------------------------|----------|
| | 2011 | 2010 | 2011 | 2010 |
| Restaurant sales | \$ 672 | \$ 1,045 | \$ 3,317 | \$ 3,730 |
| Loss from discontinued operations before income taxes | \$ (155) | \$ (145) | \$ (297) | \$ (269) |
| Income tax benefit | 9 | — | 9 | — |
| Loss from discontinued operations, net of tax | \$ (146) | \$ (145) | \$ (288) | \$ (269) |

The following table presents a rollforward of lease termination and exit costs (in thousands):

| | Balance at | Additions | Payments | Balance at |
|--|----------------------|-----------|----------|-----------------------|
| | December 31, 2010 | | | September 30, 2011 |
| Lease termination | \$— | \$1,050 | \$(533) | \$517 |
| Severance, relocation and other exit costs | — | 211 | (136) | 75 |
| Lease termination and exit costs | \$— | \$1,261 | \$(669) | \$592 |

4. Fair Value Measurements

We held investments in certificates of deposit totaling \$175,000 at September 30, 2011, which are currently classified as available-for-sale securities. These securities are valued at the original purchase price plus accrued interest and are held with a major financial institution. We have not experienced any losses on these investments to date, and we believe that we are not exposed to significant risk of loss on these investments.

5. 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 per share includes the dilutive effect of potential stock option and warrant exercises, calculated using the treasury stock method.

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|----------|------------------------------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| (In thousands, except per share data) | | | | |
| Numerator: | | | | |
| Income (loss) from continuing operations | \$ 735 | \$ (296) | \$ 1,568 | \$ (817) |
| Loss from discontinued operations, net of tax | (146) | (145) | (288) | (269) |
| Net income (loss) | \$ 589 | \$ (441) | \$ 1,280 | \$ (1,086) |
| Denominator: | | | | |
| Weighted average shares — Basic | 9,256 | 9,168 | 9,224 | 9,163 |
| Effect of dilutive stock options and warrants | 198 | — | 174 | — |

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| | | | | |
|--|---------|-----------|---------|-----------|
| Weighted average shares — Diluted | 9,454 | 9,168 | 9,398 | 9,163 |
| Basic and diluted net income (loss) per share: | | | | |
| Income (loss) from continuing operations | \$ 0.08 | \$ (0.03) | \$ 0.17 | \$ (0.09) |
| Loss from discontinued operations, net of tax | (0.02) | (0.02) | (0.03) | (0.03) |
| Net income (loss) | \$ 0.06 | \$ (0.05) | \$ 0.14 | \$ (0.12) |

6

For the three and nine months ended September 30, 2010, there were 1,000,000 stock options and warrants outstanding that were not included in the dilutive earnings per share calculation because the effect would have been anti-dilutive.

6. Accrued Expenses

Accrued expenses consisted of the following (in thousands):

| | September 30, 2011 | December 31, 2010 |
|----------------------------------|-----------------------|----------------------|
| Accrued payroll | \$ 2,250 | \$ 2,129 |
| Sales taxes | 859 | 816 |
| Gift cards | 785 | 1,140 |
| Lease termination and exit costs | 592 | — |
| Business and income taxes | 586 | 711 |
| Accrued occupancy | 347 | 233 |
| Other | 1,129 | 1,017 |
| | \$ 6,548 | \$ 6,046 |

7. Notes Payable

Equipment Loans

As of September 30, 2011, we had three equipment term loans with a lender. The aggregate outstanding principal balance of these loans was \$219,000 at September 30, 2011. The loans bear interest at rates ranging from 7.9% to 8.5% and require monthly principal and interest payments aggregating approximately \$41,000. The loans mature between October 2011 and June 2012. The loans also require us to maintain certain financial covenants, including a Fixed Charge Coverage Ratio of 1.25:1.00 calculated at the end of each calendar year. We were in compliance with all such financial covenants as of December 31, 2010.

8. Stock-Based Compensation

We maintain stock award plans under which we may issue incentive stock options, non-qualified stock options, restricted stock, and other types of awards to employees, directors, and consultants. Upon effectiveness of the 2005 Stock Award Plan, the 2002 Stock Award Plan was closed for purposes of new grants and the remaining available shares for grant, including those shares related to option awards forfeited or terminated without exercise, accrue to the 2005 Stock Award Plan. We typically grant non-qualified stock options with an exercise price at the fair market value of the underlying common stock on the date of grant and such options expire five years from the date of grant. Employee stock options generally vest 25% each year over a four-year period, while annual recurring awards for non-employee director options vest 25% each quarter over a one-year period. A total of 1,450,000 shares of common stock have been reserved for issuance under our plans of which 232,971 shares were available for grant as of September 30, 2011.

The fair value of stock options granted during the nine months ended September 30, 2011 and 2010 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, | | | |
|---------------------|---------------------------------|---|------|---|
| | 2011 | | 2010 | |
| Expected volatility | 60.0 | % | 64.3 | % |

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| | | | | |
|--|---------|---|---------|---|
| Risk-free interest rate | 1.5 | % | 1.7 | % |
| Expected option life (in years) | 3.6 | | 3.7 | |
| Dividend yield | 0.0 | % | 0.0 | % |
| Weighted average fair value per option granted | \$ 2.45 | | \$ 1.64 | |

7

The following table summarizes activity under our stock award plans for the nine months ended September 30, 2011:

| | Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|---|------------|---------------------------------------|---|------------------------------|
| Outstanding options at December 31, 2010 | 884,806 | \$ 6.28 | | |
| Granted | 285,750 | 5.53 | | |
| Forfeited | (214,500) | 7.47 | | |
| Exercised | (213,375) | 3.19 | | |
| Outstanding options at September 30, 2011 | 742,681 | \$ 6.53 | 3.1 years | \$ 804,000 |
| Exercisable at September 30, 2011 | 373,677 | \$ 8.44 | 2.5 years | \$ 325,000 |

We recognized stock-based compensation expense of \$177,000 and \$121,000 during the three months ended September 30, 2011 and 2010, respectively, and \$357,000 and \$329,000 for the nine months ended September 30, 2011 and 2010, respectively. As of September 30, 2011, there was \$542,000 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 2.5 years.

9. 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.

Stockholder Derivative Action

On February 6, 2009, Samuel Beren (“Beren” or “plaintiff”), as trustee for the Samuel Beren Trust, served a demand on us pursuant to Section 220 of Delaware’s General Corporation Law (the “DGCL”), which requested that we make available for inspection certain books and records. During April 2009, Beren, as trustee for the Samuel Beren Trust, commenced a purported stockholder derivative action in the Court of Chancery of the State of Delaware. The derivative action purportedly was brought on behalf of us against our directors and the purchasers of our promissory notes issued during March 2009, for alleged breaches of fiduciary duties by our directors, and for aiding and abetting such breaches by the purchasers of our promissory notes. We also were named as a nominal defendant in the derivative action. The derivative action sought unspecified damages, interest, reasonable attorneys’ fees, expert witness fees, and other costs.

During June 2009, the director defendants filed a motion to dismiss the derivative action. Separately, during October 2009, plaintiff served a demand on us pursuant to Section 220 of the DGCL, which requested that we make available for inspection certain books and records. During January 2010, we produced books and records in response to the October 26, 2009 demand. Two days later, plaintiff commenced a separate action against us, which sought the production of the books and records requested in plaintiff’s February 6, 2009 and October 26, 2009 demand letters. During March 2010, the court granted a stay in the derivative action until the books and records action was resolved. During July 2010, we produced books and records in response to the February 6, 2009 demand, which production was covered by a confidentiality agreement executed between us and Beren. On February 18, 2011, the

court dismissed the books and records action with prejudice.

On February 22, 2011, the plaintiff filed an amended complaint including a claim for corporate waste. On March 14, 2011, the director defendants filed a motion to dismiss the amended complaint. During June 2011, the plaintiff informed us that he did not want to pursue this matter any longer and requested a voluntary dismissal with prejudice. On July 6, 2011, the Court of Chancery of the State of Delaware granted the dismissal with prejudice as to the named plaintiff.

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 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, 2010 contained in our 2010 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, 2010 and other reports filed from time to time with the SEC.

Overview

We own and operate 23 restaurants located in 16 states. We offer freshly prepared food, attentive service, and a contemporary ambiance that create a satisfying yet affordable dining experience that we believe exceeds many traditional casual dining restaurants with which we compete. Our high-volume upscale casual restaurants feature a diverse selection of mainstream American favorites as well as a variety of appetizers and entrees with an international influence, including an extensive selection of sushi items. Our menu items are freshly prepared and incorporate over 40 signature sauces and dressings that we make from scratch, creating broad-based appeal for the lifestyle and taste trends of a diverse group of guests. We believe that our diverse menu and generous portions, combined with an average check of approximately \$25 per guest, offers our guests an attractive price-value proposition.

The restaurant industry is significantly affected by changes in economic conditions, discretionary spending patterns, consumer confidence, and other factors. Customer traffic and sales patterns have shown improvement throughout 2010 and 2011 as evidenced by the sequential improvement in our comparable restaurant sales for eight consecutive quarters. For the quarter ended September 30, 2011, our comparable restaurant sales increased 10.6% from the prior year period. We believe continued improvement in consumer confidence and spending in general, will be important and necessary catalysts to drive guest traffic and higher guest check averages in casual dining restaurants in general and our restaurants in particular.

As part of ongoing profitability initiatives, we closed our West Palm Beach, Florida and Sugar Land, Texas restaurants during the third quarter of 2011. The decision to close these restaurants was based on these restaurants' past and present operating performance and projected future results and is consistent with our strategy to eliminate unprofitable locations. The closure of these two underperforming restaurants enables us to focus on our existing restaurant portfolio while also allowing us to concentrate on developing new restaurants scheduled to open in 2012 and beyond. As a result of the restaurant closures, all historical operating results as well as lease termination and exit costs attributable to these restaurants are reflected within discontinued operations in the consolidated statements of operations for all periods presented.

We target our restaurants to achieve an average annual unit volume of \$4.5 million following 24 months of operations. One of our recent openings is trending lower than our targeted volume during the current economic environment. Our typical new restaurants experience gradually increasing unit volumes as guests discover our concept and we generate market awareness.

We experience various patterns in our operating cost structure. Cost of sales, labor, and other operating expenses for our restaurants open at least 12 months generally trend consistent with restaurant sales, and we analyze those costs as a percentage of restaurant sales. We anticipate that our new restaurants will take approximately six months to achieve operating efficiencies as a result of challenges typically associated with opening 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 has 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. The majority of our general and administrative costs are fixed costs. We expect our general and administrative spending to decrease as a percentage of restaurant sales as we leverage these investments and realize the benefits of higher sales volumes.

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. Same-store sales results for the comparable restaurant base include the results of closed restaurants for quarters during which they were in operation for the entire quarter. Same-store sales growth can be generated by an increase in guest 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.

Average Weekly Sales. Average weekly sales represents the average of restaurant sales measured over consecutive Monday through Sunday time periods.

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

Sales Per Square Foot. Sales per square foot represents the restaurant sales for our comparable restaurant base, divided by the total leasable square feet for such restaurants.

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 more easily determine future financial results driven by growth and allows investors to more easily compare restaurant level profitability.

Key Financial Definitions

Restaurant Sales. Restaurant sales include gross food and beverage sales, net of promotions and discounts.

Cost of Sales. Cost of sales consists of food and beverage costs.

Labor. Labor includes all direct and indirect labor costs incurred in operations.

Occupancy. Occupancy includes all rent payments associated with the leasing of real estate, including base, percentage and straight-line rent, property taxes, and common area maintenance expense. We record tenant improvement allowances as a reduction of occupancy expense over the initial term of the lease.

Restaurant Operating Expenses. Restaurant operating expenses consist of all other restaurant-level operating costs, the major components of which are utilities, credit card fees, advertising, supplies, marketing, repair and maintenance, and other expenses. Other operating expenses contain both variable and fixed components.

General and Administrative. General and administrative includes all corporate and administrative functions that support operations and provide infrastructure to facilitate our future growth. Components of this category include management and staff salaries, bonuses, stock-based compensation and related employee benefits, travel, information systems, human resources, training, corporate rent, professional and consulting fees, and corporate insurance costs.

Preopening Expense. Preopening expense consists of costs incurred prior to opening a new restaurant and is comprised principally of manager salaries and relocation, payroll and related training costs for new employees, including food and beverage costs associated with practice and rehearsal of service activities, and rent expense incurred from the date we obtain possession of the property until opening. We expense restaurant preopening expenses as incurred, and we expect preopening expenses to be similar for each new restaurant opening, which typically commence six to eight months prior to a restaurant opening. Our preopening costs will fluctuate from period to period depending upon the number of restaurants opened, the timing of new restaurant openings, the location of the restaurants, and the complexity of the staff hiring and training process.

Depreciation and Amortization. Depreciation and amortization expense consists of the depreciation of property and equipment.

Interest Income and Other, Net. Interest income and other, net consists of interest earned on our cash and investments and any gains or losses on our investments.

Interest Expense. Interest expense includes the cost of servicing our debt obligations, net of capitalized interest.

Discontinued Operations. Discontinued operations include the historical operating results as well as lease termination and exit costs attributable to closed restaurants.

Financial Performance Overview

The following table sets forth certain information regarding our financial performance for the three and nine months ended September 30, 2011 and 2010.

| | Three Months Ended | | | | Nine Months Ended | | | |
|--|--------------------|---|----------|---|-------------------|---|----------|---|
| | September 30, | | 2010 | | September 30, | | 2010 | |
| | 2011 | | 2010 | | 2011 | | 2010 | |
| Restaurant sales growth | 15.9 | % | 7.9 | % | 14.6 | % | 7.6 | % |
| Same-store sales percentage change (1) | 10.6 | % | 0.0 | % | 9.2 | % | (0.9) | % |
| Average weekly sales – comparable restaurant base (2) | \$79,800 | | \$72,100 | | \$77,750 | | \$71,200 | |
| Average unit volume (in thousands) (2) | \$1,038 | | \$932 | | \$3,036 | | \$2,853 | |
| Sales per square foot (2) | \$147 | | \$132 | | \$430 | | \$404 | |
| Restaurant operating profit (in thousands) (3) | \$4,371 | | \$2,907 | | \$12,223 | | \$9,364 | |
| Restaurant operating profit as a percentage of sales (3) | 18.3 | % | 14.1 | % | 17.3 | % | 15.2 | % |

(1) Same-store sales percentage change reflects the periodic change in restaurant sales for the comparable restaurant base. In calculating the percentage change for same-store sales, we include a restaurant in the comparable restaurant base after it has been in operation for more than 18 months. Same-store sales results for the comparable restaurant base include the results of closed restaurants for quarters during which they were in operation for the entire quarter.

(2) Includes only those restaurants in the comparable restaurant base.

(3) Restaurant operating profit is not a financial measurement determined in accordance with U.S. generally accepted accounting principles and should not be considered in isolation or as an alternative to loss 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.

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-----------------------------------|-------------------------------------|----------|------------------------------------|----------|
| | 2011 | 2010 | 2011 | 2010 |
| | (In thousands) | | | |
| Restaurant sales | \$23,838 | \$20,560 | \$70,591 | \$61,614 |
| Costs and expenses: | | | | |
| Cost of sales | 6,372 | 5,623 | 19,251 | 16,430 |
| Labor | 7,815 | 7,081 | 23,365 | 21,367 |
| Occupancy | 1,742 | 1,634 | 5,125 | 4,888 |
| Restaurant operating expenses | 3,538 | 3,315 | 10,627 | 9,565 |
| Restaurant operating profit | 4,371 | 2,907 | 12,223 | 9,364 |
| Deduct – other costs and expenses | | | | |
| General and administrative | 2,117 | 1,446 | 6,147 | 5,456 |
| Preopening expense | — | 382 | — | 509 |
| Depreciation and amortization | 1,474 | 1,371 | 4,419 | 4,138 |
| Income (loss) from operations | \$780 | \$(292) | \$1,657 | \$(739) |

| | Percentage of Restaurant Sales Three Months Ended September 30, | | | | Percentage of Restaurant Sales Nine Months Ended September 30, | | | |
|-----------------------------------|---|---|-------|----|--|---|-------|----|
| | 2011 | | 2010 | | 2011 | | 2010 | |
| Restaurant sales | 100.0 | % | 100.0 | % | 100.0 | % | 100.0 | % |
| Costs and expenses: | | | | | | | | |
| Cost of sales | 26.7 | | 27.3 | | 27.3 | | 26.7 | |
| Labor | 32.8 | | 34.4 | | 33.1 | | 34.7 | |
| Occupancy | 7.3 | | 7.9 | | 7.3 | | 7.9 | |
| Restaurant operating expenses | 14.8 | | 16.1 | | 15.1 | | 15.5 | |
| Restaurant operating profit | 18.3 | | 14.1 | | 17.3 | | 15.2 | |
| Deduct – other costs and expenses | | | | | | | | |
| General and administrative | 8.9 | | 7.0 | | 8.7 | | 8.9 | |
| Preopening expense | 0.0 | | 1.9 | | 0.0 | | 0.8 | |
| Depreciation and amortization | 6.2 | | 6.7 | | 6.3 | | 6.7 | |
| Income (loss) from operations | 3.3 | % | (1.4) |)% | 2.3 | % | (1.2) |)% |

Certain percentage amounts do not sum to total due to rounding.

The following table sets forth changes in the number of restaurants opened for the periods indicated:

| | Nine Months Ended September 30, 2011 | Year Ended December 31, 2010 |
|---------------------|---|------------------------------------|
| Beginning of period | 25 | 24 |
| Openings | — | 1 |
| Closings | (2) | — |
| End of period | 23 | 25 |

Results of Operations

The following table sets forth, for the periods indicated, the percentage of restaurant sales of certain items in our financial statements:

| | Three Months Ended | | | | Nine Months Ended | | | |
|---|--------------------|---------|---------------|---------|-------------------|---------|---------------|---------|
| | September 30, | | September 30, | | September 30, | | September 30, | |
| | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 |
| Restaurant sales | 100.0 | % 100.0 | % 100.0 | % 100.0 | 100.0 | % 100.0 | % 100.0 | % 100.0 |
| Costs and expenses: | | | | | | | | |
| Cost of sales | 26.7 | 27.3 | 27.3 | 26.7 | | | | |
| Labor | 32.8 | 34.4 | 33.1 | 34.7 | | | | |
| Occupancy | 7.3 | 7.9 | 7.3 | 7.9 | | | | |
| Restaurant operating expenses | 14.8 | 16.1 | 15.1 | 15.5 | | | | |
| General and administrative | 8.9 | 7.0 | 8.7 | 8.9 | | | | |
| Preopening expense | 0.0 | 1.9 | 0.0 | 0.8 | | | | |
| Depreciation and amortization | 6.2 | 6.7 | 6.3 | 6.7 | | | | |
| Total costs and expenses | 96.7 | 101.4 | 97.7 | 101.2 | | | | |
| Income (loss) from operations | 3.3 | (1.4) | 2.3 | (1.2) | | | | |
| Nonoperating income (expense): | | | | | | | | |
| Interest income and other, net | 0.0 | 0.1 | 0.0 | 0.1 | | | | |
| Interest expense | (0.1) | (0.0) | (0.1) | (0.2) | | | | |
| Income (loss) from continuing operations before | | | | | | | | |
| provision for income taxes | 3.2 | (1.4) | 2.2 | (1.3) | | | | |
| Provision for income taxes | 0.1 | 0.0 | 0.0 | 0.0 | | | | |
| Income (loss) from continuing operations | 3.1 | (1.4) | 2.2 | (1.3) | | | | |
| Loss from discontinued operations, net of tax | (0.6) | (0.7) | (0.4) | (0.4) | | | | |
| Net income (loss) | 2.5 | % (2.1) | % 1.8 | % (1.8) | | | | |

Certain percentage amounts do not sum to total due to rounding.

Three Months Ended September 30, 2011 Compared with Three Months Ended September 30, 2010

Restaurant Sales. Restaurant sales increased \$3.3 million, or 15.9% to \$23.8 million during the third quarter of 2011 from \$20.6 million during the third quarter of 2010. The \$3.3 million increase in restaurant sales is attributable to a 10.6% increase in comparable restaurant sales and \$1.1 million in sales generated by our Baltimore, Maryland restaurant which opened in October 2010. The increase in comparable restaurant sales resulted from a 2.5% increase in guest traffic, higher average check per guest aided by new menu offerings, and an estimated effective menu price increase of approximately 3.3%.

Cost of Sales. Cost of sales increased \$0.7 million, or 13.3% to \$6.4 million during the third quarter of 2011 from \$5.6 million during the prior year period. The increase was primarily the result of the opening of the new Baltimore restaurant in October 2010 and incremental food and liquor costs associated with higher sales volumes. As a percentage of restaurant sales, cost of sales decreased 0.6% to 26.7% during the third quarter of 2011 from 27.3% during the third quarter of 2010. The decrease in cost of sales as a percentage of restaurant sales during the third quarter of 2011 reflects cost savings from various purchasing and culinary initiatives as well as leverage from the

3.3% menu price increase.

13

Labor. Labor costs for our restaurants increased \$0.7 million, or 10.4% to \$7.8 million during the third quarter of 2011 from \$7.1 million during the third quarter of 2010. The increase was primarily the result of the opening of the new Baltimore restaurant in October 2010 and increased staffing levels to support higher average weekly sales. Labor expenses as a percentage of restaurant sales decreased 1.6% to 32.8% during the third quarter of 2011 from 34.4% during the prior year period. The decrease in labor costs as a percentage of restaurant sales was primarily due to our ability to leverage fixed management wages and hourly labor expenses resulting from the 10.6% increase in comparable restaurant sales.

Occupancy. Occupancy expenses increased \$0.1 million, or 6.6% to \$1.7 million during the third quarter of 2011 from \$1.6 million during the third quarter of 2010. The increase in occupancy expenses is attributable to occupancy expenses associated with the new Baltimore restaurant that opened in October 2010 and an increase in percentage rent charges for certain locations based upon higher sales volumes. Occupancy expenses as a percentage of restaurant sales decreased 0.6% to 7.3% during the third quarter of 2011 from 7.9% during the prior year period. The decrease in occupancy costs as a percentage of sales reflects increased leverage of the fixed portion of these costs from higher average weekly sales.

Restaurant Operating Expenses. Restaurant operating expenses increased \$0.2 million, or 6.7% to \$3.5 million during the third quarter of 2011 from \$3.3 million during the prior year period. The increase in restaurant operating expenses is attributable to the opening of the new Baltimore restaurant in October 2010. Restaurant operating expenses as a percentage of restaurant sales decreased 1.3% to 14.8% during the third quarter of 2011, as compared to 16.1% during the third quarter of 2010, reflecting the leverage of fixed and variable operating costs from higher average weekly sales.

General and Administrative. General and administrative expenses increased \$0.7 million, or 46.4% to \$2.1 million during the third quarter of 2011 compared to \$1.4 million during the third quarter of 2010. The increase in general and administrative expenses during the third quarter of 2011 is attributable to higher incentive compensation expense related to our 2011 financial performance and increased legal and professional fees. General and administrative expenses as a percentage of restaurant sales increased 1.9% to 8.9% of restaurant sales during the third quarter of 2011, as compared to 7.0% during the third quarter of 2010.

Preopening Expense. We did not incur any preopening expense during the third quarter of 2011, as no new restaurants are currently scheduled to open during 2011. We incurred \$0.4 million in preopening expense during the third quarter of 2010 related to our new Baltimore restaurant that opened in October 2010. Preopening expense varies each quarter based upon the number of restaurants opened and the timing of new restaurant openings as the majority of preopening expense is incurred during the two months preceding an opening.

Depreciation and Amortization. Depreciation and amortization expense increased \$0.1 million, or 7.5%, to \$1.5 million during the third quarter of 2011 from \$1.4 million during the prior year period. The increase in depreciation and amortization expense is attributable to depreciation expense for one restaurant that opened in October 2010. Depreciation and amortization expense as a percentage of restaurant sales decreased 0.5%, to 6.2% during the third quarter of 2011 from 6.7% during the prior year period reflecting leverage of these fixed costs from higher average weekly sales.

Discontinued Operations. Discontinued operations represent the historical operating results as well as lease termination and exit costs attributable to the two restaurants closed during the third quarter of 2011. See Note 3 to the Unaudited Consolidated Financial Statements. Our loss from discontinued operations was nearly unchanged at \$146,000 in the third quarter of 2011 compared to \$145,000 in the prior year period.

Provision for Income Taxes. During the third quarter of 2011, we recorded a provision for income taxes of \$19,000, primarily for state taxes.

Nine Months Ended September 30, 2011 Compared with Nine Months Ended September 30, 2010

Restaurant Sales. Restaurant sales increased by \$9.0 million, or 14.6% to \$70.6 million during the first nine months of 2011 from \$61.6 million during the prior year period, primarily attributable to a 9.5% increase in comparable restaurant sales and restaurant sales generated from the opening of the new Baltimore restaurant in October 2010. The increase in comparable restaurant sales is due to a 3.0% increase in guest traffic, higher average guest check aided by new menu offerings, and an estimated effective menu price increase of approximately 2.4%.

Cost of Sales. Cost of sales increased \$2.8 million, or 17.2% to \$19.2 million during the first nine months of 2011 from \$16.4 million during the first nine months of 2010. The increase in cost of sales during the first nine months of 2011 reflects year-over-year cost increases for certain seafood, produce, dry goods, and dairy ingredients coupled with costs of sales associated with the new Baltimore restaurant opened in October 2010 and incremental food and liquor costs associated with higher sales volumes. Cost of sales as a percentage of restaurant sales increased 0.6% to 27.3% during the first nine months of 2011 from 26.7% during the prior year period. The increase in cost of sales as a percentage of sales is attributable to higher commodity prices, upgrades of certain food ingredients as part of our menu evolution project and increased discounts for free products offered as part of our Konavore™ loyalty and other marketing programs. The food and beverage portion of these marketing programs is recorded in cost of sales.

Labor. Labor costs for our restaurants increased \$2.0 million, or 9.4% to \$23.4 million during the first nine months of 2011 from \$21.4 million during the prior year period. The increase was primarily due to the opening of the new Baltimore restaurant in October 2010 and incremental labor costs to support the 9.5% growth in comparable restaurant sales. As a percentage of restaurant sales, labor costs decreased 1.6% to 33.1% during the first nine months of 2011 from 34.7% during the first nine months of 2010. The decrease in labor costs as a percentage of restaurant sales was primarily due to our ability to leverage fixed management wages and hourly labor expenses resulting from the 9.5% increase in comparable restaurant sales.

Occupancy. Occupancy expense increased \$0.2 million, or 4.8% to \$5.1 million during the first nine months of 2011 from \$4.9 million during the prior year period. The increase in occupancy expenses is attributable to occupancy expenses associated with the new Baltimore restaurant that opened in October 2010 and an increase in percentage rent charges for certain locations based upon higher sales volumes. Occupancy expenses as a percentage of restaurant sales decreased 0.6% to 7.3% during the first nine months of 2011 from 7.9% during the first nine months of 2010. The decrease in occupancy costs as a percentage of sales reflects increased leverage of the fixed portion of these costs from higher average weekly sales.

Restaurant Operating Expenses. Restaurant operating expenses increased by \$1.1 million, or 11.1% to \$10.6 million during the first nine months of 2011 from \$9.5 million during the prior year period. The increase in restaurant operating expenses is attributable to the opening of the new Baltimore restaurant in October 2010, coupled with an increase in the variable portion of operating expenses associated with higher average weekly sales volumes. Restaurant operating expenses as a percentage of restaurant sales decreased 0.4% to 15.1% during the first nine months of 2011 from 15.5% during the prior year period. The reduction in restaurant operating expenses as a percentage of sales is attributable to increased leverage of fixed operating costs resulting from higher average weekly sales.

General and Administrative. General and administrative expenses increased \$0.7 million, or 12.7% to \$6.1 million during the first nine months of 2011 from \$5.4 million during the prior year period. The increase in general and administrative expenses is primarily due to \$0.3 million in severance and related charges associated with the resignation of our former CEO and higher incentive compensation expense related to our 2011 financial performance. General and administrative expenses as a percentage of restaurant sales decreased 0.2% to 8.7% of restaurant sales during the first nine months of 2011 compared to 8.9% of restaurant sales during the prior year period.

Preopening Expense. We did not incur any preopening expense during the first nine months of 2011 as no new restaurants are currently scheduled to open during 2011. We incurred \$0.5 million in preopening expense during the first nine months of 2010 related to the new Baltimore restaurant that opened in October 2010.

Depreciation and Amortization. Depreciation and amortization expense increased \$0.3 million, or 6.8% to \$4.4 million during the first nine months of 2011 from \$4.1 million during the prior year period. The increase in depreciation and amortization expense is due to depreciation expense for one restaurant that opened in October 2010. Depreciation and amortization expense as a percentage of restaurant sales decreased 0.4% to 6.3% during the first nine months of 2011 from 6.7% during the prior year period, reflecting leverage of these fixed costs from higher average weekly sales.

Discontinued Operations. Discontinued operations represent the historical operating results as well as lease termination and exit costs attributable to the two restaurants closed during the third quarter of 2011. See Note 3 to the Unaudited Consolidated Financial Statements. Our loss from discontinued operations was relatively flat at \$288,000 during the first nine months of 2011 compared to \$269,000 in the first nine months of 2010.

Provision for Income Taxes. During the first nine months of 2011, we recorded a \$44,000 provision for income taxes compared to \$10,000 during the prior year period. The provision for the first nine months of 2011 primarily reflects income taxes for certain states in which we operate that do not calculate tax based upon net income. The provision for the first nine months of 2010 reflected the benefit of an anticipated refund of prior year taxes due to a change in tax legislation regarding net operating loss carrybacks, partially offset by state taxes.

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;
- restaurant operating costs and preopening costs for our newly-opened restaurants, which are often materially greater during the first several months of operation than thereafter;
- labor availability and costs 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;
- outside shareholder activities;
- 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 decrease.

Liquidity and Capital Resources

Our primary capital requirements are for new restaurant development and remodeling of existing restaurants. Similar to many restaurant chains, 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 to perform site-related work and to construct and equip each restaurant. The average investment cost for our restaurants depends upon the type of lease entered into, the amount of tenant improvement allowance we receive from landlords, and whether we assume responsibility for the construction of the building. We expect the cash investment cost of our typical restaurant to be approximately \$2.5 million, net of landlord tenant improvement allowances of between \$0.7 million and \$1.2 million, and excluding cash preopening expenses of approximately \$0.4 million. We expect these costs will vary from one market to another based on real estate values, zoning regulations, permitting requirements, labor markets and other variables. Restaurants that are subject to ground leases and do not receive landlord tenant improvement allowances typically require a significantly higher cash investment. We also require capital resources to maintain our existing base of restaurants and to further expand and strengthen the capabilities of our corporate and information technology infrastructures.

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

| | September 30, 2011 | December 31, 2010 |
|----------------------------------|-----------------------|----------------------|
| Cash and short-term investments | \$ 6,018 | \$ 2,729 |
| Net working capital (deficit)(1) | (1,180) | (4,878) |

(1) The working capital deficits at September 30, 2011 and December 31, 2010, are primarily attributable to accruals for payroll and professional fees. The working capital deficit at September 30, 2011 also includes lease termination and exit costs related to our two closed restaurants.

| | Nine Months Ended September 30, | |
|---------------------------------------|---------------------------------|----------|
| | 2011 | 2010 |
| Cash provided by operating activities | \$ 4,375 | \$ 3,230 |
| Capital expenditures | 1,153 | 3,478 |

Future Capital Requirements

Our capital requirements, including development costs related to the opening of new restaurants, have historically been significant. Over the last several years, we funded development of new restaurants primarily from the proceeds of equity financing and cash flows from operations. Our future cash requirements and the adequacy of available funds will depend on many factors, including the operating performance of our restaurants, the pace of expansion, real estate markets, site locations, the nature of the arrangements negotiated with landlords and the credit market environment.

Our current operations generate sufficient cash flow to fund operations and general and administrative costs. We believe existing cash and short-term investments of \$6.0 million in addition to cash flow from operations will be sufficient to fund planned remodels of existing restaurants, moderate new restaurant development and lease termination costs on the two closed restaurants. Any reduction of our cash flow from operations may cause a delay or cancellation of future restaurant development or remodels of existing restaurants. As of September 30, 2011, we had a

working capital deficit of \$1.2 million, a decrease of \$3.7 million from December 31, 2010, as a result of cash flows generated from operations during the first nine months of 2011. We plan to reduce this deficit further through cost containment efforts and cash flow from operations. Financing to construct new restaurants 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 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.

Equipment Loans

As of September 30, 2011, we had three equipment term loans with a lender. The aggregate outstanding principal balance of these loans was \$219,000 at September 30, 2011. The loans bear interest at rates ranging from 7.9% to 8.5% and require monthly principal and interest payments aggregating approximately \$41,000. The loans mature between October 2011 and June 2012. The loans also require us to maintain certain financial covenants, including a Fixed Charge Coverage Ratio of 1.25:1.00 calculated at the end of each calendar year. We were in compliance with all such financial covenants as of December 31, 2010.

Cash Flows

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

| | Nine Months Ended September 30, | |
|--|---------------------------------|----------|
| | 2011 | 2010 |
| Net cash provided by (used in): | | |
| Operating activities | \$ 4,375 | \$ 3,230 |
| Investing activities | (1,212) | 2,645 |
| Financing activities | 125 | (6,268) |
| Net increase (decrease) in cash and cash equivalents | \$ 3,288 | \$ (393) |

Operating Activities. Our cash flows from operating activities, as detailed in the Unaudited Consolidated Statements of Cash Flows, provided \$4.4 million of net cash during the first nine months of 2011. The net increase in cash from operating activities for the first nine months of 2011 in comparison to the first nine months of 2010, is primarily the result of higher net income partially offset by a reduction in accounts payable and deferred rent.

Investing Activities. Capital expenditures for the nine months ended September 30, 2011 were \$1.2 million and were primarily attributable to contractor payments for our Baltimore, Maryland restaurant that opened during October 2010 and remodeling costs for existing restaurants. Investing activities for the nine months ended September 30, 2010 reflect contractor payments for the new Baltimore restaurant that opened in October 2010 and two restaurants that opened during the second half of 2009, as well as proceeds from the sale of \$5.8 million in auction rate securities and \$0.3 million in other investments.

Financing Activities. Net cash provided by financing activities was \$0.1 million for the nine months ended September 30, 2011, reflecting \$0.5 million in proceeds from stock issued as part of our stock option and employee stock purchase plans partially offset by \$0.4 million in principal payments on equipment loans. Net cash used in financing activities for the first nine months of 2011 was \$6.3 million, reflecting the repayment of \$5.8 million under our line of credit and \$0.5 million in principal payments on equipment loans.

Critical Accounting Policies

Critical accounting policies are those that we believe are most important to the portrayal of our financial condition and results of operations and also require our most difficult, subjective, or complex judgments. Judgments or uncertainties regarding the application of these policies may result in materially different amounts being reported under various conditions or using different assumptions. There have been no material changes to the critical accounting policies previously reported in our Annual Report on Form 10-K for the year ended December 31, 2010.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The following discussion of market risks contains forward-looking statements. Actual results may differ materially from the following discussion based on general conditions in the commodity markets.

Primary Market Risk Exposures

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 helps 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.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We have evaluated, with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer have each concluded that our disclosure controls and procedures are effective to ensure that we record, process, summarize, and report information required to be disclosed by us in our quarterly reports filed under the Exchange Act within the time periods specified by the SEC'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.

Changes in Internal Control over Financial Reporting

During the quarterly period covered by this report, there have not been any changes in our internal controls over financial reporting 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

Stockholder Derivative Action

On February 6, 2009, Samuel Beren ("Beren" or "plaintiff"), as trustee for the Samuel Beren Trust, served a demand on us pursuant to Section 220 of Delaware's General Corporation Law (the "DGCL"), which requested that we make available for inspection certain books and records. During April 2009, Beren, as trustee for the Samuel Beren Trust, commenced a purported stockholder derivative action in the Court of Chancery of the State of Delaware. The derivative action purportedly was brought on behalf of us against our directors and the purchasers of our promissory notes issued during March 2009, for alleged breaches of fiduciary duties by our directors, and for aiding and abetting such breaches by the purchasers of our promissory notes. We also were named as a nominal defendant in the derivative action. The derivative action sought unspecified damages, interest, reasonable attorneys' fees, expert witness fees, and other costs.

During June 2009, the director defendants filed a motion to dismiss the derivative action. Separately, during October 2009, plaintiff served a demand on us pursuant to Section 220 of the DGCL, which requested that we make available for inspection certain books and records. During January 2010, we produced books and records in response to the October 26, 2009 demand. Two days later, plaintiff commenced a separate action against us, which sought the production of the books and records requested in plaintiff's February 6, 2009 and October 26, 2009 demand letters. During March 2010, the court granted a stay in the derivative action until the books and records action was

resolved. During July 2010, we produced books and records in response to the February 6, 2009 demand, which production was covered by a confidentiality agreement executed between us and Beren. On February 18, 2011, the court dismissed the books and records action with prejudice.

On February 22, 2011, the plaintiff filed an amended complaint including a claim for corporate waste. On March 14, 2011, the director defendants filed a motion to dismiss the amended complaint. During June 2011, the plaintiff informed us that he did not want to pursue this matter any longer and requested a voluntary dismissal with prejudice. On July 6, 2011, the Court of Chancery of the State of Delaware granted the dismissal with prejudice as to the named plaintiff.

Item 1A. Risk Factors

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, 2010. 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. (Removed and Reserved).

Item 5. Other Information

Not applicable.

Item 6. Exhibits

Exhibit

Number Exhibit

10.29 Employment Agreement, dated as of October 24, 2011, between the Company and Michael A. Nahkunst. (1)

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 pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101 Interactive data files pursuant to Rule 405 of Regulation S-T (i) the Consolidated Balance Sheets as of September 30, 2011 and December 31, 2010, (ii) the Unaudited Consolidated Statements of Operations for

the three and nine months ended September 30, 2011 and 2010, (iii) the Unaudited Consolidated Statements of Cash Flows for the nine months ended September 30, 2011 and 2010 and (iv) the notes to the Unaudited Consolidated Financial Statements.

(1) Incorporated by reference to the Registrant's Form 8-K filed on October 26, 2011

20

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/ Michael A. Nahkunst
Michael A. Nahkunst
President and Chief Executive Officer
(Principal Executive Officer)

/s/ Mark S. Robinow
Mark S. Robinow
Executive Vice President, Chief Financial
Officer, and Secretary (Principal
Accounting and Financial Officer)

Date: November 10, 2011