KONA GRILL INC
Form 10-Q
November 03, 2009

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

FORM 10-Q

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

For the quarterly period ended September 30, 2009

or

o **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	**20-0216690**
(State or other jurisdiction of incorporation or organization)	*(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 þ No o

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 o No o

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 o	Accelerated filer o	Non-accelerated filer þ	Smaller reporting company o
		(Do not check if a 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 o No þ

As of October 31, 2009, there were 9,143,856 shares of the registrant s common stock outstanding.

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PART I FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

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

	September 30, 2009 (Unaudited)	December 31, 2008 (Note 1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 2,516	$ 2,477
Investments	6,268	370
Receivables	501	980
Other current assets	1,107	938
Total current assets	10,392	4,765
Long-term investments		6,491
Other assets	702	794
Property and equipment, net	56,591	53,504
Total assets	$ 67,685	$ 65,554
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 1,761	$ 4,335
Accrued expenses	5,830	4,878
Current portion of notes payable	715	717
Line of credit	5,798	2,488
Total current liabilities	14,104	12,418
Notes payable	789	1,320
Deferred rent	15,779	16,218
Total liabilities	30,672	29,956
Commitments and contingencies (Note 11)		
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, 9,260,056 shares issued and 9,143,856 shares outstanding at September 30, 2009 and 6,628,191 shares issued and 6,511,991 shares outstanding at December 31, 2008	93	66
Additional paid-in capital	57,472	53,739
	(1,000)	(1,000)

Treasury stock, at cost, 116,200 shares at September 30, 2009 and December 31, 2008				
Accumulated deficit		(19,552)		(17,207)
Total stockholders equity		37,013		35,598
Total liabilities and stockholders equity	$	67,685	$	65,554

See accompanying notes to the unaudited consolidated financial statements.

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

	Three Months Ended September 30, 2009	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Restaurant sales	$ 20,173	$ 19,454	$ 61,096	$ 57,242
Costs and expenses:				
Cost of sales	5,267	5,254	15,825	15,816
Labor	7,117	6,496	21,135	19,003
Occupancy	1,655	1,260	4,711	3,760
Restaurant operating expenses	3,296	2,978	9,568	8,468
General and administrative	1,590	2,079	6,138	5,957
Preopening expense	480	471	1,332	1,190
Depreciation and amortization	1,820	1,656	5,373	4,806
Total costs and expenses	21,225	20,194	64,082	59,000
Loss from operations	(1,052)	(740)	(2,986)	(1,758)
Nonoperating income (expense):				
Interest income and other, net	44	62	169	371
Interest expense	(22)		(153)	(51)
Loss from continuing operations before provision for income taxes	(1,030)	(678)	(2,970)	(1,438)
Provision for income taxes	5	55	65	205
Loss from continuing operations	(1,035)	(733)	(3,035)	(1,643)
Gain (loss) from discontinued operations, net of tax		(3,161)	690	(3,459)
Net loss	$ (1,035)	$ (3,894)	$ (2,345)	$ (5,102)
Net (loss) income per share basic and diluted (Note 5):				
Continuing operations	$ (0.11)	$ (0.09)	$ (0.36)	$ (0.20)
Discontinued operations		(0.40)	0.08	(0.43)
Net loss	$ (0.11)	$ (0.49)	$ (0.28)	$ (0.63)
Weighted average shares used in computation (Note 5):				
Basic	9,141	7,998	8,478	8,071
Diluted	9,141	7,998	8,478	8,071

See accompanying notes to the unaudited consolidated financial statements.

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

	Nine Months Ended September 30,	
	2009	**2008**
Operating activities		
Net loss	$ (2,345)	$ (5,102)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	5,373	5,063
Stock-based compensation expense	392	403
Amortization of debt discount	70	
Asset impairment charge in discontinued operations		2,158
Change in operating assets and liabilities:		
Receivables	479	(1,955)
Other current assets	(169)	(88)
Accounts payable	(40)	667
Accrued expenses	952	264
Deferred rent	(439)	3,012
Net cash provided by operating activities	4,273	4,422
Investing activities		
Purchase of property and equipment	(10,994)	(12,516)
Decrease (increase) in other assets	92	(78)
Net purchases and sales of investments	593	7,221
Net cash used in investing activities	(10,309)	(5,373)
Financing activities		
Net borrowings on line of credit	3,310	
Proceeds from bridge loan	1,200	
Repayment of bridge loan	(1,200)	
Repayments of notes payable	(533)	(493)
Proceeds from issuance of common stock, net of issuance costs	3,245	
Proceeds from issuance of common stock under the Employee Stock Purchase Plan and exercise of stock options and warrants	53	66
Purchase of treasury stock		(1,000)
Net cash provided by (used in) financing activities	6,075	(1,427)
Net increase (decrease) in cash and cash equivalents	39	(2,378)
Cash and cash equivalents at the beginning of the period	2,477	4,991
Cash and cash equivalents at the end of the period	$ 2,516	$ 2,613

Supplemental disclosure of cash flow information				
Cash paid for interest, net of capitalization	$	83	$	51
Noncash investing activities				
(Decrease) increase in accounts payable related to property and equipment additions	$	(2,534)	$	1,059

See accompanying notes to the unaudited consolidated financial statements.

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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) 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 currently own and operate 23 restaurants in 15 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 month periods ended September 30, 2009 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009.

The consolidated balance sheet at December 31, 2008 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, 2008.

Recent Accounting Pronouncements

In April 2009, the FASB issued additional application guidance and enhanced disclosures regarding fair value measurements and impairment of securities. The guidance includes how to determine the fair value of assets and liabilities when the volume and level of activity for the asset or liability has significantly decreased. Enhanced disclosure requirements include the following: 1) interim disclosures regarding the fair values of financial instruments that are not currently reflected on the balance sheet at fair value; and 2) disclosure on the methods and significant assumptions used to estimate the fair value of financial instruments on an interim basis as well as changes of the methods and significant assumptions from prior periods. We adopted the additional guidance and disclosure requirements as of our second quarter ended June 30, 2009. The adoption did not have a material effect on our financial condition or results of operations.

In May 2009, the FASB issued its pronouncement regarding subsequent events which provides guidance to establish general standards of accounting for, and disclosures of, events that occur after the balance sheet date but before financial statements are issued or are available to be issued. In connection with preparation of the consolidated financial statements, we evaluated subsequent events after the balance sheet date of September 30, 2009 through November 3, 2009, the date the financial statements were issued.

In June 2009, the FASB approved the FASB Accounting Standards Codification (the Codification) as the single source of authoritative nongovernmental GAAP. All existing accounting standard documents, such as the FASB, American Institute of Certified Public Accountants, Emerging Issues Task Force and other related literature, excluding guidance from the SEC, have been superseded by the Codification. All non-grandfathered, non-SEC accounting literature not included in the Codification has become non-authoritative. The Codification does not change GAAP, but instead introduces a new structure that combines all authoritative standards into a comprehensive, topically organized online database. The Codification is effective for our September 30, 2009 financial statements and impacts financial statement disclosures as all references to authoritative accounting literature are referenced in accordance with the Codification.

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2. Discontinued Operations

Discontinued operations include results attributable to our Naples, Florida restaurant that was closed during the third quarter of 2008. Gain (loss) from discontinued operations includes both the historical results of operations as well as exit costs. During the second quarter of 2009, we entered into a settlement agreement for the termination of the lease for $700,000. As the settlement amount was less than the lease termination accrual previously recorded during 2008, we recorded a gain of $690,000, after deducting fees and other expenses, for the nine months ended September 30, 2009. Gain (loss) from discontinued operations, net of tax is comprised of the following (in thousands):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2009		2008		2009		2008	
Restaurant sales	$		$	340	$		$	1,531
Gain (loss) from discontinued operations before income tax benefit	$		$	(3,186)	$	690	$	(3,534)
Income tax benefit				25				75
Gain (loss) from discontinued operations, net of tax	$		$	(3,161)	$	690	$	(3,459)

Activity associated with the lease termination accrual is summarized below (in thousands):

Balance at December 31, 2008	$	1,417
Cash payments		(456)
Non-cash activity		(690)
Balance at September 30, 2009	$	271

Non-cash activity reflects the updated estimate of lease termination costs based upon the settlement agreement discussed above. The lease settlement requires an initial payment of $350,000 that was paid during July 2009 and the remaining amount, including interest at a 6% annual rate, is payable in 12 equal monthly installments beginning in August 2009. Settlement fees of $271,000 are included in accrued expenses on the accompanying consolidated balance sheet as of September 30, 2009.

3. Investments

The following is a summary of our investments (in thousands):

	Adjusted Cost		Gross Unrealized Losses		Estimated Fair Value	
September 30, 2009						
Short-term investments:						
Certificates of deposit	$	171	$		$	171
Money market securities		314				314
Auction rate securities		5,386				5,386
Put option on auction rate securities		397				397
Total investments	$	6,268	$		$	6,268

December 31, 2008

Short-term investments:						
Certificates of deposit	$	370	$		$	370
Long-term investments:						
Auction rate securities		5,858				5,858
Put option on auction rate securities		633				633
		6,491				6,491
Total investments	$	6,861	$		$	6,861

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As of September 30, 2009, our investment portfolio included auction rate securities with a par value of $5,800,000. These securities are AAA rated long term debt obligations secured by student loans, substantially all of which are guaranteed by the federal government under the Federal Family Education Loan Program. While the maturity dates of our auction rate securities range from 2029 to 2046, liquidity for these securities has historically been provided by an auction process that resets the applicable interest rate at pre-determined calendar intervals, generally every 28 days. Since February 2008, events in the credit markets have adversely affected the auction market for these types of securities and auctions for our securities have failed to settle on their respective settlement dates. During August 2009, we were able to sell $800,000 of these securities at par value. The proceeds from the sale were used to pay down a portion of the outstanding balance under the line of credit.

Our auction rate securities are classified as trading securities as they are subject to an agreement we entered into with UBS during October 2008 pursuant to which UBS issued to us Series C-2 Auction Rate Securities Rights. The agreement allows us the right to sell our auction rate securities to UBS at full par value between June 30, 2010 and July 2, 2012. In conjunction with this agreement, we elected to apply the provisions of fair value accounting to this put option because the put option does not provide for net settlement, and the auction rate securities themselves are not readily convertible to cash. The put option does not meet the definition of a derivative, and thus, would not be marked to fair value. We therefore elected to apply fair value accounting to our put option as the put option acts as an economic hedge against any further price movement in the auction rate securities and enables us to recognize future changes in the fair value of the put option as those changes occur to offset fair value movements in the auction rate securities. Also as part of this agreement, UBS agreed to provide a line of credit through June 30, 2010 that is secured by the auction rate securities held with UBS. Both the put option and the auction rate securities are marked to market value through the consolidated statements of operations each period (see Note 4 for discussion of how fair value measurements are determined). At September 30, 2009, the fair value of the put option was $397,000 and the fair value of the auction rate securities was $5,386,000. We recorded a net gain of $31,000 and $92,000 for the three and nine months ended September 30, 2009, respectively, for the fair value measurement of both the auction rate securities and the put option that is included in interest income and other, net. As of June 30, 2009, we reclassified our auction rate securities and put option from long-term to short-term investments on our consolidated balance sheet due to the expected timing of when these securities will be redeemed at par value by UBS. We continue to earn interest on our auction rate securities at the maximum contractual rate. Interest earned on the auction rate securities is used to reduce the outstanding balance under the line of credit.

4. Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, a three-tier value hierarchy has been established, which prioritizes the inputs used in the valuation methodologies in measuring fair value.

Level 1: Fair values determined by quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access.

Level 2: Fair values utilize inputs other than quoted prices that are observable for the asset or liability, and may include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability.

Level 3: Fair values determined by unobservable inputs that are not corroborated by market data and may reflect the reporting entity s own assumptions market participants would use in pricing the asset or liability.

Our short-term investments in fixed income and money market securities represent available-for-sale securities that are valued primarily using quoted market prices or alternative pricing sources and models utilizing market observable inputs. Money market securities represent collateral for a letter of credit required under certain lease obligations.

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Our investment in auction rate securities are classified within Level 3 because they are valued using a discounted cash flow model. We estimate the fair value of auction rate securities using valuation models provided by third parties and internal analyses. The valuation models require numerous assumptions and assessments, including the following: (i) collateralization underlying each security; (ii) present value of future principal and interest payments discounted at rates considered to reflect current market conditions; (iii) creditworthiness of the counterparty; and (iv) current illiquidity of the investments.

The fair value of the put option is determined through comparison of the fair value of each auction rate security to its par value and then discounted by a rate reflective of the risk of default by UBS between the valuation date and the expected exercise date of the put option. A discounted cash flow approach is used to value the difference between the par value and fair value of each security using a discount rate that considers the credit risk associated with UBS and the expected timing of when the put option will be exercised. The put option is adjusted on each balance sheet date based on its then fair value. The fair value of the put option is based on unobservable inputs and is therefore classified within Level 3 in the hierarchy. The following table presents information about our assets measured at fair value on a recurring basis at September 30, 2009, and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value (in thousands):

	Fair Value Measurements at Reporting Date Using			
Description	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**September 30, 2009**
Certificates of deposit	$ 171	$	$	$ 171
Money market securities	314			314
Auction rate securities			5,386	5,386
Put option on auction rate securities			397	397
	$ 485	$	$ 5,783	$ 6,268

The following table summarizes the changes in fair value of our Level 3 assets (in thousands):

	Auction rate securities	Put option on auction rate securities
Balance at December 31, 2008	$ 5,858	$ 633
Transfer to Level 3		
Total gains or losses (realized and unrealized)		
Included in earnings	328	(236)
Included in other comprehensive loss		
Net settlements	(800)	
Balance at September 30, 2009	$ 5,386	$ 397

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5. Net Loss Per Share

Basic net loss is computed by dividing net loss by the weighted average number of common shares outstanding during the period. Diluted net loss per share excludes the dilutive effect of potential stock option and warrant exercises, which are calculated using the treasury stock method.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
	(In thousands, except per share data)			
Numerator:				
Loss from continuing operations	$ (1,035)	$ (733)	$ (3,035)	$ (1,643)
Gain (loss) from discontinued operations		(3,161)	690	(3,459)
Net loss	$ (1,035)	$ (3,894)	$ (2,345)	