KONA GRILL INC
Form 10-Q
November 07, 2008

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, 2008

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 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 (Do not check if a smaller reporting company)	Smaller reporting company o

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, 2008, there were 6,501,870 shares of the registrant s common stock outstanding.

TABLE OF CONTENTS

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

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

	September 30, 2008 (Unaudited)	December 31, 2007 (Note 1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 2,613	$ 4,991
Investments	367	14,188
Receivables	3,051	1,096
Other current assets	1,481	1,393
Total current assets	7,512	21,668
Long-term investments	5,971	
Other assets	573	495
Property and equipment, net	53,665	47,311
Total assets	$ 67,721	$ 69,474
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 5,050	$ 3,324
Accrued expenses	4,289	4,025
Current portion of notes payable	703	663
Total current liabilities	10,042	8,012
Notes payable	1,504	2,037
Deferred rent	16,006	12,994
Total liabilities	27,552	23,043
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, 6,618,070 and 6,608,078 shares issued and outstanding at September 30, 2008 and December 31, 2007, respectively	66	66
Additional paid-in capital	53,540	53,071
Treasury stock, at cost, 116,200 shares and zero shares at September 30, 2008 and December 31, 2007, respectively	(1,000)	
Accumulated deficit	(11,808)	(6,706)
Accumulated other comprehensive loss	(629)	

Total stockholders equity		40,169		46,431
Total liabilities and stockholders equity	$	67,721	$	69,474

See accompanying notes to the unaudited consolidated financial statements.

Table of Contents

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

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Restaurant sales	$ 19,454	$ 18,652	$ 57,242	$ 52,064
Costs and expenses:				
Cost of sales	5,254	5,166	15,816	14,700
Labor	6,496	5,581	19,003	15,942
Occupancy	1,260	1,153	3,760	3,313
Restaurant operating expenses	2,978	2,514	8,468	7,084
General and administrative	2,079	1,885	5,957	5,486
Preopening expense	471	367	1,190	1,205
Depreciation and amortization	1,656	1,394	4,806	3,980
Total costs and expenses	20,194	18,060	59,000	51,710
(Loss) income from operations	(740)	592	(1,758)	354
Nonoperating income (expense):				
Interest income	62	140	371	431
Interest expense		(37)	(51)	(79)
(Loss) income from continuing operations before provision for income taxes	(678)	695	(1,438)	706
Provision for income taxes	55	74	205	147
(Loss) income from continuing operations	(733)	621	(1,643)	559
Loss from discontinued operations, net of tax	(3,161)	(177)	(3,459)	(345)
Net (loss) income	$ (3,894)	$ 444	$ (5,102)	$ 214
Net (loss) income per share Basic:				
Continuing operations	$ (0.11)	$ 0.11	$ (0.25)	$ 0.10
Loss from discontinued operations, net of tax	(0.49)	(0.03)	(0.53)	(0.06)
Net (loss) income	$ (0.60)	$ 0.08	$ (0.78)	$ 0.04
Net (loss) income per share Diluted:				
Continuing operations	$ (0.11)	$ 0.10	$ (0.25)	$ 0.09
Loss from discontinued operations, net of tax	(0.49)	(0.03)	(0.53)	(0.06)

Net (loss) income	$	(0.60)	$	0.07	$	(0.78)	$	0.03
Weighted average shares used in computation:								
Basic		6,498		5,891		6,557		5,870
Diluted		6,498		6,238		6,557		6,231

See accompanying notes to the unaudited consolidated financial statements.

Table of Contents

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

	Nine Months Ended September 30, 2008	2007
Operating activities		
Net (loss) income	$ (5,102)	$ 214
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization	5,063	4,252
Stock-based compensation expense	403	451
Asset impairment charge in discontinued operations	2,158	
Tax benefit on exercise of stock options		5
Change in operating assets and liabilities:		
Receivables	(1,955)	326
Other current assets	(88)	(692)
Accounts payable	667	(952)
Accrued expenses	264	634
Deferred rent	3,012	286
Net cash provided by operating activities	4,422	4,524
Investing activities		
Purchase of property and equipment	(12,516)	(9,184)
Increase in other assets	(78)	(32)
Net proceeds on purchase and sale of investments	7,221	5,671
Net cash used in investing activities	(5,373)	(3,545)
Financing activities		
Repayments of notes payable	(493)	(456)
Purchase of treasury stock	(1,000)	
Proceeds from issuance of common stock under the Employee Stock Purchase Plan and exercise of stock options	66	241
Net cash used in financing activities	(1,427)	(215)
Net (decrease) increase in cash and cash equivalents	(2,378)	764
Cash and cash equivalents at the beginning of the period	4,991	1,934
Cash and cash equivalents at the end of the period	$ 2,613	$ 2,698
Supplemental disclosure of cash flow information		
Cash paid for interest, net of capitalization	$ 51	$ 79
Noncash investing activities		
Increase (decrease) in accounts payable related to property and equipment	$ 1,059	$ (1,648)

See accompanying notes to the unaudited consolidated financial statements.

Table of Contents

KONA GRILL, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation and Significant Accounting Policies

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 18 restaurants in 11 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 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, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008.

The consolidated balance sheet at December 31, 2007 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, 2007.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash, money market funds, and highly liquid short-term fixed income securities with a maturity of 90 days or less when acquired. Amounts receivable from credit card processors are also considered cash equivalents because they are both short-term and highly liquid in nature and are typically converted to cash within one business day of the sales transaction. Under our asset classification practices, when there is no legal right of offset against cash balances in a specific financial institution, uncleared checks are classified as accounts payable. Uncleared checks totaling approximately $1,746,000 and $1,013,000 were included in accounts payable as of September 30, 2008 and December 31, 2007, respectively.

Recent Accounting Pronouncements

Effective January 1, 2008, we adopted Statement of Financial Accounting Standard No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. See Note 4 for further discussion of fair value measurements.

In February 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position No. FAS 157-2, *Effective Date of FASB Statement No. 157* (SFAS 157-2), which provides a one year deferral of the effective date of SFAS 157 for non-financial assets and non-financial liabilities. We do not expect that the provisions of SFAS 157-2 will have a material impact on our consolidated financial statements.

On October 10, 2008, the FASB issued FASB Staff Position No. FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active*, (SFAS 157-3) that clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. SFAS 157-3 is applicable to the valuation of auction rate securities held by the Company for which there was no active market as of September 30, 2008. The Company has considered the guidance provided by SFAS 157-3 in its determination of estimated fair values as of September 30, 2008, and the impact was not material.

2. Discontinued Operations

On September 13, 2008, we closed our Naples, Florida restaurant to focus more on the profitable locations and position our concept to generate profit from operations. As a result of the closure, we recorded long-lived asset impairment charges of $2,158,000 as well as ongoing contractual lease obligations, restaurant-level closing costs, and employee termination benefits, net of deferred costs, of approximately $760,000 during the third quarter of 2008. Contractual lease obligations associated with the Naples closure are included in deferred rent on our accompanying consolidated balance sheets.

We determined that the closure met the criteria for classification as a discontinued operation as of September 30, 2008. Accordingly, all impairment charges and exit costs, along with the sales, costs and expenses and income taxes attributable to this restaurant have been aggregated within loss from discontinued operations, net of tax on our consolidated statements of operations for all periods presented. Loss from discontinued operations, net of tax on our accompanying consolidated statements of operations is comprised of the following (in thousands):

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Restaurant sales	$ 340	$ 558	$ 1,531	$ 2,135
Loss from discontinued operations before income tax benefit	$ (3,186)	$ (191)	$ (3,534)	$ (387)
Income tax benefit	25	14	75	42
Loss from discontinued operations, net of tax	$ (3,161)	$ (177)	$ (3,459)	$ (345)

3. Investments

The following is a summary of available-for-sale securities (in thousands):

	Adjusted Cost	Gross Unrealized Losses	Fair Value
September 30, 2008			
Short-term investments:			
Certificates of deposit	$ 367	$	$ 367
Long-term investments:			
Auction rate securities	6,600	(629)	5,971
Total investments	$ 6,967	$ (629)	$ 6,338
December 31, 2007			
Short-term investments:			
Auction rate securities	$ 8,650	$	$ 8,650
Corporate debt securities	5,538		5,538
Total investments	$ 14,188	$	$ 14,188

As of September 30, 2008, our investment portfolio included auction rate securities with a par value of $6.6 million. These securities are primarily AAA rated long term debt obligations secured by student loans, of which approximately $6.0 million or 90% of the par value is guaranteed by the federal government under the Federal Family Education

Loan Program. In addition, one of the securities not fully comprised of federal government guaranteed loans is AA rated, but has an insurance policy guaranteeing both the principal and accrued interest. 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. The recent uncertainties in the credit markets have adversely affected the auction market for these types of securities and auctions for these securities have failed to settle on their respective settlement dates. As of September 30, 2008, we classified our auction rate securities as long-term investments on our consolidated balance sheet due to the expected timing of when these securities can be settled at par value. See Note 11 for discussion of the settlement agreement with our investment provider.

Table of Contents

Typically the fair value of auction rate securities approximated par value due to the frequent resets through the auction process. We continue to earn interest on our auction rate securities with current yields of approximately 2.8% as of September 30, 2008. As a result of the liquidity issues experienced in the credit markets, all of our auction rate securities have experienced failed auctions since February 2008 and therefore do not currently have a readily determinable market value. We estimated the fair value of our auction rate securities using valuation models provided by third parties. The assumptions used in the models included assessments of the following: (i) collateralization underlying each security; (ii) the present value of future principal and interest payments discounted at rates considered to reflect current market conditions; (iii); the creditworthiness of the counterparty; and (iv) the current illiquidity of the investments. Based on these valuation models, we estimated the fair value of our auction rate securities to be $6.0 million as of September 30, 2008. As a result, we recorded an unrealized loss of $0.6 million for the nine months ended September 30, 2008.

We review our investments in accordance with FASB Staff Position SFAS No. 115-1 and 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,* to determine the classification of the impairment as temporary or other-than-temporary. A temporary impairment charge results in an unrealized loss being recorded in the other comprehensive loss component of stockholders equity. Such an unrealized loss does not affect net loss for the applicable accounting period. An other-than-temporary impairment charge is recorded as a realized loss in the consolidated statement of operations and increases net loss for the applicable accounting period. The determination of whether the impairment is temporary or other-than-temporary requires significant judgment. The differentiating factors between temporary and other-than-temporary impairment are primarily the length of time and the extent to which the market value has been less than cost, the financial condition and near-term prospects of the issuer and our intent and ability to retain our investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value. We do not consider our investments in auction rate securities to be other-than-temporarily impaired at September 30, 2008.

4. Fair Value Measurements

Effective January 1, 2008, we adopted SFAS 157 for our financial instruments. SFAS 157 defines fair value 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, SFAS 157 establishes a three-tier value hierarchy, 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 Company 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 represent fixed income securities that are valued primarily using quoted market prices or alternative pricing sources and models utilizing market observable inputs. Our investments in auction rate securities are classified within Level 3 because they are valued using a discounted cash flow model (see Note 3). The following table presents information about our assets measured at fair value on a recurring basis at September 30, 2008, and indicates the fair value hierarchy of the valuation techniques utilized by us to determine such fair value (in thousands).

	Fair Value Measurements at Reporting Date Using		
	Quoted Prices in Active Markets	Significant Other Observable	Significant Unobservable

Description	for Identical Assets (Level 1)		Inputs (Level 2)	Inputs (Level 3)		September 30, 2008	
Certificates of deposit	$	367	$	$		$	367
Auction rate securities					5,971		5,971
	$	367	$	$	5,971	$	6,338

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

	Fair Value Measurements of Assets Using Level 3 Inputs Long-term Investments	
Balance at December 31, 2007	$	
Transfer to Level 3		8,650
Total gains or losses (realized and unrealized)		
Included in earnings		
Included in other comprehensive loss		(629)
Net settlements		(2,050)
Balance at September 30, 2008	$	5,971

5. Net (Loss) Income Per Share

Basic net (loss) income is computed by dividing net (loss) income 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.

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2008		2007		2008		2007	
	(In thousands, except per share data)							
Numerator:								
(Loss) income from continuing operations	$	(733)	$	621	$	(1,643)	$	559
Loss from discontinued operations		(3,161)		(177)		(3,459)		(345)
Net (loss) income	$	(3,894)	$	444	$	(5,102)	$	214
Denominator:								
Weighted average shares Basic		6,498		5,891		6,557		5,870
Effect of dilutive stock options and warrants				347				361
Weighted average shares Diluted		6,498		6,238		6,557		6,231