

KONA GRILL INC
Form 10-Q
May 05, 2016

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 March 31, 2016

or

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

For the transition period from _____ to _____

Commission File Number 001-34082

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 333
Scottsdale, Arizona 85251**

(480) 922-8100

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes No

As of April 30, 2016, there were 11,211,161 shares of the registrant’s common stock outstanding.

KONA GRILL, INC.

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PART I – FINANCIAL INFORMATION**Item 1. Financial Statements****KONA GRILL, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(in thousands, except share data)**

| | March 31, 2016 (Unaudited) | December 31, 2015 (Note 1) |
|---|--|--|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 3,453 | \$ 9,055 |
| Short-term investments | 178 | 178 |
| Receivables | 635 | 1,574 |
| Inventory | 1,825 | 1,865 |
| Prepaid expenses and other current assets | 252 | 692 |
| Total current assets | 6,343 | 13,364 |
| Other assets | 1,226 | 1,228 |
| Property and equipment, net | 95,831 | 87,252 |
| Total assets | \$ 103,400 | \$ 101,844 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 3,554 | \$ 4,548 |
| Accrued expenses | 13,740 | 14,282 |
| Total current liabilities | 17,294 | 18,830 |
| Long term debt | 5,000 | — |
| Deferred rent and other long term liabilities | 20,645 | 20,323 |
| Total liabilities | 42,939 | 39,153 |
| Commitments and contingencies (Note 10) | | |
| Stockholders' equity: | | |
| Preferred stock, \$0.01 par value, 2,000,000 shares authorized, none issued | — | — |
| Common stock, \$0.01 par value, 30,000,000 shares authorized, 11,327,361 shares issued and 11,211,161 shares outstanding at March 31, 2016; 11,387,724 shares issued and 11,271,524 shares outstanding at December 31, 2015 | 114 | 114 |
| Additional paid-in capital | 97,608 | 98,182 |

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| | | |
|---|------------|------------|
| Accumulated deficit | (36,261) | (34,605) |
| Treasury stock, at cost, 116,200 shares at March 31, 2016 and December 31, 2015 | (1,000) | (1,000) |
| Total stockholders' equity | 60,461 | 62,691 |
| Total liabilities and stockholders' equity | \$ 103,400 | \$ 101,844 |

See accompanying notes to condensed consolidated financial statements.

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

| | Three Months Ended March 31, | |
|--|---|-------------|
| | 2016 | 2015 |
| Restaurant sales | \$39,277 | \$32,807 |
| Costs and expenses: | | |
| Cost of sales | 10,501 | 9,062 |
| Labor | 14,118 | 11,388 |
| Occupancy | 3,249 | 2,357 |
| Restaurant operating expenses | 5,639 | 4,608 |
| General and administrative | 3,516 | 3,283 |
| Preopening expenses | 711 | 817 |
| Depreciation and amortization | 3,121 | 2,184 |
| Total costs and expenses | 40,855 | 33,699 |
| Income (loss) from operations | (1,578) | (892) |
| Interest expense, net | 53 | 45 |
| Income (loss) before income taxes | (1,631) | (937) |
| Income tax expense (benefit) | 25 | (12) |
| Net income (loss) | \$(1,656) | \$(925) |
| Net income (loss) per share: | | |
| Basic | \$(0.15) | \$(0.08) |
| Diluted | \$(0.15) | \$(0.08) |
| Weighted average shares used in computation: | | |
| Basic | 11,258 | 11,235 |
| Diluted | 11,258 | 11,235 |
| Comprehensive income (loss) | \$(1,656) | \$(925) |

See accompanying notes to condensed consolidated financial statements.

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

| | Three Months Ended March 31, | |
|---|---|-------------|
| | 2016 | 2015 |
| Operating activities | | |
| Net income (loss) | \$(1,656) | \$(925) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Depreciation and amortization | 3,121 | 2,184 |
| Stock-based compensation | 299 | 301 |
| Amortization of deferred financing costs | 21 | 20 |
| Change in operating assets and liabilities: | | |
| Receivables | 939 | (538) |
| Inventory | 40 | 72 |
| Prepaid expenses and other current assets | 440 | 396 |
| Accounts payable | (248) | (372) |
| Accrued expenses | (437) | (396) |
| Deferred rent and other long term liabilities | 322 | 844 |
| Net cash provided by operating activities | 2,841 | 1,586 |
| Investing activities | | |
| Purchase of property and equipment | (12,551) | (6,561) |
| Change in other assets | (19) | (63) |
| Net cash used in investing activities | (12,570) | (6,624) |
| Financing activities | | |
| Borrowings under credit facility | 5,000 | — |
| Purchase and retirement of common stock | (984) | — |
| Proceeds from issuance of common stock under the Employee Stock Purchase Plan and exercise of stock options | 111 | 458 |
| Net cash provided by financing activities | 4,127 | 458 |
| Net change in cash and cash equivalents | (5,602) | (4,580) |
| Cash and cash equivalents at the beginning of the period | 9,055 | 36,578 |
| Cash and cash equivalents at the end of the period | \$3,453 | \$31,998 |
| Supplemental disclosure of cash flow information | | |
| Cash paid for interest, net of capitalized interest | \$30 | \$25 |
| Cash paid for income taxes, net of refunds | \$26 | \$(27) |

Noncash investing activities

| | | |
|---|---------|---------|
| Accounts payable and accruals related to property and equipment | \$6,416 | \$3,873 |
|---|---------|---------|

See accompanying notes to condensed consolidated financial statements.

KONA GRILL, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. Basis of Presentation

Kona Grill, Inc., including its wholly-owned subsidiaries, (referred to herein as the “Company” or “we,” “us,” and “our”) develops, owns and operates upscale casual dining restaurants under the name “Kona Grill.” Our restaurants feature a diverse selection of flavorful American favorites and award-winning sushi items that are prepared fresh daily at each restaurant location. As of March 31, 2016, we owned and operated 37 restaurants in 19 states and Puerto Rico. In April 2016, we opened a new restaurant in Irvine, California and currently have operations in 20 states and Puerto Rico. Our chief operating decision maker function is comprised of our Chief Executive Officer and Chief Financial Officer who manage our restaurant operation base that aggregates into one reportable segment. Accordingly, we have a single operating segment and reporting unit structure.

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

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

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

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

consolidated balance sheets. Territory fees are recognized as income on a pro-rata basis at the same time the individual franchise fees for each location are considered earned, typically when the individual franchise unit is opened. We have not recognized any franchise related income in the quarter ended March 31, 2016.

Recently Issued Accounting Standards

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

In April 2015, the FASB issued ASU 2015-03, Interest – Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs. This guidance requires debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying value of that debt liability. The recognition and measurement guidance for debt issuance costs are not affected by this new guidance. The adoption of this guidance in the first quarter of 2016 did not have a material impact on our consolidated financial statements.

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

In July 2015, the FASB issued ASU 2015-11, Inventory (Topic 330). The pronouncement was issued to simplify the measurement of inventory and changes the measurement from lower of cost or market to lower of cost and net realizable value. This pronouncement is effective for reporting periods beginning after December 15, 2016. The adoption of ASU 2015-11 is not expected to have a significant impact on the Company’s consolidated financial position or results of operations.

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

In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation (Topic 718) which simplifies the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. The standard is effective for fiscal years beginning after December 31, 2016, and interim periods within those fiscal years, with early adoption permitted. We are currently evaluating the timing and the impact of adopting the standard.

2. Fair Value Measurements

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

3. Net Income (Loss) Per Share

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

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

| | Three Months Ended | |
|---------------------------------------|-------------------------------|-------------|
| | March 31, | |
| | 2016 | 2015 |
| (In thousands, except per share data) | | |
| Numerator: | | |
| Net income (loss) | \$(1,656) | \$(925) |
| Denominator: | | |
| Weighted average shares — Basic | 11,258 | 11,235 |
| Effect of dilutive stock options | — | — |
| Weighted average shares — Diluted | 11,258 | 11,235 |
| Net income (loss) per share: | | |
| Basic | \$(0.15) | \$(0.08) |
| Diluted | \$(0.15) | \$(0.08) |

For the three months ended March 31, 2016 and 2015, there were 846,000 and 581,000 stock options outstanding, respectively, that were not included in the dilutive earnings per share calculation because the effect would have been anti-dilutive.

4. Property and Equipment

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

| | March 31, 2016 | December 31, 2015 |
|--|-------------------------------|----------------------------------|
| Leasehold improvements | \$99,973 | \$96,473 |
| Equipment | 26,509 | 25,825 |
| Furniture and fixtures | 11,586 | 11,126 |
| | 138,068 | 133,424 |
| Less accumulated depreciation and amortization | (57,154) | (54,027) |
| | 80,914 | 79,397 |
| Construction in progress | 14,917 | 7,855 |
| Total property and equipment, net | \$95,831 | \$87,252 |

We capitalize direct internal payroll and travel costs on the construction of leasehold improvements incurred during the development and construction period. Capitalized costs were \$269,000 and \$182,000 in the three months ended March 31, 2016 and 2015, respectively.

5. Accrued Expenses

Accrued expenses consisted of the following (in thousands):

| | March 31, 2016 | December 31, 2015 |
|---|-------------------------------|----------------------------------|
| Accrued payroll and benefits | \$3,747 | \$3,786 |
| Accrued construction and remodel costs ⁽¹⁾ | 4,911 | 5,017 |
| Gift card liability | 1,886 | 2,309 |
| Sales taxes | 1,621 | 1,678 |
| Accrued occupancy | 326 | 296 |
| Business and income taxes | 293 | 321 |
| Other | 956 | 875 |
| Total accrued expenses | \$13,740 | \$14,282 |

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

6. Debt and Credit Agreements

On April 19, 2013, we entered into a Credit Agreement for a \$20 million revolving line of credit maturing on April 19, 2017 with KeyBank National Association (“KeyBank”) and Stearns Bank National Association (“Stearns Bank”). On November 7, 2014, we entered into an Amended and Restated Credit Agreement (the “Amended Credit Agreement”) with KeyBank to (i) increase the credit facility from \$20 million to \$35 million, and (ii) extend the maturity date of the credit facility to November 7, 2019. The credit facility is secured by our personal property and assets. Certain of our wholly owned subsidiaries have also guaranteed the credit facility. We had \$5 million in outstanding borrowings and \$30 million available under the credit facility at March 31, 2016. In April 2016, we borrowed another \$4 million under the credit facility. We may from time to time request that the total revolving credit commitment be increased up to an amount not to exceed \$60 million. Any such increase is subject to agreement of the respective lenders in the lending syndicate or new lenders in certain circumstances. Any such increase, which may be for a lesser amount than requested by us, is also subject to certain other terms and conditions as provided in the Amended Credit Agreement.

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

We incurred gross interest expense of \$53,000 and \$45,000 during the quarter ended March 31, 2016 and 2015, consisting primarily of loan fee amortization of \$21,000 and \$20,000, respectively, and commitment fees of \$26,000 and \$22,000, respectively. Unamortized loan fees of \$301,000 at March 31, 2016 are being amortized over the life of the credit facility and are included in other assets in the consolidated balance sheet. Capitalized interest was immaterial for the quarter ended March 31, 2016 and none for the quarter ended March 31, 2015, respectively.

We generally use available cash to repay any borrowings under the credit facility and any remaining balances are maintained by extending the maturities of the borrowings. Our current projections indicate that we will maintain the outstanding borrowings for the next 12 months and, as a result, all borrowings under the credit facility are classified as long-term debt.

The credit facility also requires us to comply with certain covenants, including (a) a fixed charge coverage ratio of not less than 1.50 and (b) a maximum leverage ratio of 5.0 to 1.0 through March 31, 2016 and 4.75 to 1.0 from April 1, 2016 through the maturity date. We were in compliance with all covenants at March 31, 2016.

7. Income Taxes

We recorded an income tax expense of \$25,000 during the three months ended March 31, 2016 and income tax benefit of \$12,000 during the three months ended March 31, 2015. The income tax expense for the three months ended March 31, 2016 consists of state income tax expenses for which no net operating losses or other credits exist. The income tax benefit for the three months ended March 31, 2015 relates to refunds of \$27,000 primarily associated with prior year federal income tax partially offset by state income tax expense of \$15,000 for which no net operating loss carryforwards or other credits exist.

At March 31, 2016, we had approximately \$21 million in deferred tax assets primarily related to state net operating loss carryforwards and federal business tax credit carryforwards. We have a full valuation allowance for these

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

8. Stock-Based Compensation

The fair value of stock options granted during the three months ended March 31, 2016 and 2015 was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

| | Three Months Ended March 31, | |
|--|---|-------------|
| | 2016 | 2015 |
| Expected volatility | 45.2% | 40.7% |
| Risk-free interest rate | 0.9 % | 0.9 % |
| Expected option life (in years) | 3.2 | 3.0 |
| Dividend yield | 0.0 % | 0.0 % |
| Weighted average fair value per option granted | \$4.57 | \$6.74 |

The following table summarizes our stock option activity for the three months ended March 31, 2016:

| | Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value |
|--|----------------|--|---|--|
| Outstanding options at December 31, 2015 | 961,468 | \$ 15.15 | | |
| Granted | 251,532 | 14.26 | | |
| Forfeited | (5,600) | 15.59 | | |
| Exercised | (19,050) | 5.20 | | |
| Outstanding options at March 31, 2016 | 1,188,350 | \$ 15.12 | 3.1 | \$1,972,000 |
| Exercisable at March 31, 2016 | 582,900 | \$ 13.34 | 2.3 | \$1,682,000 |

We recognized stock-based compensation expense of \$0.3 million in each of the three months ended March 31, 2016 and 2015, respectively. As of March 31, 2016, there was \$2.8 million 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 2.7 years.

The total shares of common stock reserved for issuance totaled 3.7 million, of which 1.3 million shares were available for grant as of March 31, 2016.

9. Stock Purchase and Retirement Program

In November 2015, our Board of Directors authorized a repurchase program of up to \$10.0 million of our outstanding common stock. As of March 31, 2016, we have repurchased and retired \$1.2 million or 98,600 shares under the 2015 authorization, including \$1.0 million or 80,406 shares during the first quarter of 2016.

The authorization of the program does not have an expiration date and it does not require us to purchase a specific dollar amount of shares. This authorization may be modified, suspended or terminated at any time. The timing and number of shares purchased pursuant to the share purchase authorization are subject to a number of factors, including current market conditions, legal constraints and available cash. If we do not continue to repurchase shares of our common stock, this could have an adverse effect on the market price of our common stock.

10. Commitments and Contingencies

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

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

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

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

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

Overview

We currently own and operate 38 restaurants located in 20 states and Puerto Rico. We offer freshly prepared food, attentive service, and a contemporary ambiance that create a satisfying yet affordable dining experience that we believe exceeds the experience at many traditional casual dining restaurants with which we compete. Our high-volume upscale casual restaurants feature a global menu of contemporary American favorites, award-winning sushi and specialty cocktails. Our menu items are freshly prepared and incorporate over 40 signature sauces and dressings that we make from scratch at each restaurant location, creating broad-based appeal for the lifestyle and taste trends of a diverse group of customers. We believe that our diverse menu and generous portions, combined with an average check of approximately \$26 per person, offer our customers an attractive price-value proposition.

We plan to grow organically through unit expansion, with a goal of 20% unit growth annually over the next several years. We achieved a unit growth rate of 23% for 2015, with seven openings during the year. We plan to open eight restaurants during 2016 and currently have ten signed leases for new restaurant openings in 2016 and beyond. We continue working diligently to build our pipeline for future growth.

We continue to execute our strategy for international market expansion. Given the strength our concept has enjoyed thus far in the U.S. and the increased demand for upscale casual dining concepts overseas, we believe there is a significant opportunity to expand our concept in Latin America, the Middle East and beyond. In February and April 2016, we announced agreements for the development of six Kona Grill restaurants in Mexico and six restaurants in the United Arab Emirates over the next seven years. We expect our first international location to open during the first half of 2017.

We continue to focus on growing sales and successfully opening new restaurants. Our same-store sales increased 3.6% year over year compared to a 2.2% increase in same-store sales in the first quarter of 2015. We have generated positive same-store sales in each of the past 5 years.

The average unit volume of our comparable base restaurants was \$1.1 million in both the first quarter of 2016 and 2015. We generated a loss from operations of \$1.6 million and \$0.9 million in the first quarter of 2016 and 2015, respectively, and net loss of \$1.7 million and \$0.9 million in the first quarter of 2016 and 2015, respectively. A significant part of the change was driven by incremental operating costs for new restaurant locations, higher depreciation and amortization resulting from new restaurants and remodeling activities and higher general and administrative expenses in support of our accelerated unit growth and international business development.

Our restaurant operating profit, defined as restaurant sales minus cost of sales, labor, occupancy, and restaurant operating expenses, increased 7.0% to \$5.8 million in the first quarter of 2016 from \$5.4 million in the first quarter of 2015. Restaurant operating profit as a percentage of restaurant sales of 14.7% in the first quarter of 2016 included new restaurant operating inefficiencies for ten restaurants in the non-comparable restaurant base. Restaurant operating profit as a percentage of restaurant sales of 16.4% in the first quarter of 2015 included new restaurant operating inefficiencies for eight restaurants in the non-comparable restaurant base. Our Adjusted EBITDA, defined as income (loss) from operations plus depreciation and amortization, preopening expenses, stock-based compensation and other, was \$2.6 million and \$2.4 million in the first quarter of 2016 and 2015, respectively. Adjusted EBITDA as a percentage of restaurant sales was 6.5% in the first quarter of 2016 compared to 7.3% in the first quarter of 2015, primarily reflecting the operating inefficiencies in our new restaurants, our investment in human capital to accelerate our unit growth and start-up costs for international business development. See “Key Measures” and “Financial Performance Overview” below for further information on restaurant operating profit and Adjusted EBITDA, including a reconciliation to our income (loss) from operations.

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

Key Measures We Use to Evaluate Our Company

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

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

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

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

Average Weekly Sales. Average weekly sales represent the average of restaurant sales for the comparable restaurant base measured over consecutive Monday through Sunday time periods.

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

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

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

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 and related delivery fees.

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 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 Expenses. Preopening expenses consist of costs incurred prior to opening a new restaurant and are 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. We expect preopening expenses to commence six to eight months prior to a restaurant opening. Although the actual preopening expenses for a particular location depend upon numerous factors, our historical cash preopening expenses average approximately \$450,000 per location, and non-cash preopening rent expense typically ranges from \$50,000 to \$100,000 per location. 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. Depreciation and amortization expense also includes accelerated depreciation expense and gains or losses on the disposal of fixed assets, primarily associated with remodel activities.

Interest Expense, net. Interest expense consists of the cost of servicing our debt obligations, the amortization of debt issuance costs and commitment fees on the line of credit. Interest expense is offset by interest earned on cash and cash equivalents and investment balances. We capitalize interest incurred on borrowings for restaurant construction.

Income Tax Provision. Provision for income taxes represents amounts due for federal and state income taxes.

Financial Performance Overview

The following table sets forth certain information regarding our financial performance for the three months ended March 31, 2016 and 2015. There were 26 and 23 restaurants in the comparable restaurant base as of March 31, 2016 and 2015, respectively.

| | Three Months Ended March 31, | | | |
|---|---------------------------------|---|----------|---|
| | 2016 | | 2015 | |
| Change in restaurant sales | 19.7 | % | 18.8 | % |
| Same-store sales percentage change ⁽¹⁾ | 3.6 | % | 2.2 | % |
| Average weekly sales – comparable restaurant base | \$88,500 | | \$86,600 | |
| Average weekly sales – non-comparable restaurant base | \$70,500 | | \$80,400 | |
| Average unit volume (in thousands) ⁽²⁾ | \$1,140 | | \$1,113 | |
| Restaurant operating profit (in thousands) ⁽³⁾ | \$5,770 | | \$5,392 | |
| Restaurant operating profit as a percentage of sales ⁽³⁾ | 14.7 | % | 16.4 | % |
| Adjusted EBITDA (in thousands) ⁽⁴⁾ | \$2,553 | | \$2,410 | |
| Adjusted EBITDA as a percentage of sales ⁽⁴⁾ | 6.5 | % | 7.3 | % |

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

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

Restaurant operating profit is not a financial measurement determined in accordance with U.S. generally accepted accounting principles (see reconciliation below) and should not be considered in isolation or as an alternative to income from operations. Restaurant operating profit may not be comparable to the same or similarly titled

(3) measures computed by other companies. We believe restaurant operating profit is an important component of financial results because it is a widely used metric within the restaurant industry to evaluate restaurant-level productivity, efficiency, and performance. We use restaurant operating profit as a percentage of restaurant sales as a key metric to evaluate our restaurants' financial performance compared with our competitors.

Adjusted EBITDA is not a financial measure determined in accordance with U.S. generally accepted accounting principles (see reconciliation below) and should not be considered in isolation or as an alternative to income from operations. Adjusted EBITDA is defined as income (loss) from operations plus depreciation and amortization, preopening expenses and stock-based compensation. Adjusted EBITDA is presented because: (i) we believe it is a

(4) useful measure for investors to assess the operating performance of our business without the effect of non-cash items such as depreciation and amortization expenses and stock-based compensation as well as the costs of opening new restaurants; (ii) we believe that investors will find these measures useful in assessing our ability to service or incur indebtedness; and (iii) we use Adjusted EBITDA internally as a benchmark to evaluate our operating performance and compare our performance to that of our competitors.

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

| | Three Months Ended March 31, 2016 2015 | |
|-------------------------------|--|----------|
| (In thousands) | | |
| Income (loss) from operations | \$(1,578) | \$(892) |
| Depreciation and amortization | 3,121 | 2,184 |
| Preopening expenses | 711 | 817 |
| Stock-based compensation | 299 | 301 |
| Adjusted EBITDA | 2,553 | 2,410 |
| General and administrative | 3,516 | 3,283 |
| Stock-based compensation | (299) | (301) |
| Restaurant operating profit | \$5,770 | \$5,392 |

| | Percentage of Restaurant Sales Three Months Ended March 31, 2016 2015 | |
|-------------------------------|---|---------|
| Income (loss) from operations | (4.0)% | (2.7)% |
| Depreciation and amortization | 7.9 | 6.7 |
| Preopening expenses | 1.8 | 2.5 |
| Stock-based compensation | 0.8 | 0.9 |
| Adjusted EBITDA | 6.5 | 7.3 |
| General and administrative | 9.0 | 10.0 |
| Stock-based compensation | (0.8) | (0.9) |
| Restaurant operating profit | 14.7 % | 16.4 % |

Certain amounts may not sum due to rounding.

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 | |
|-----------------------------------|-------------------------------|-------------|
| | March 31, | |
| | 2016 | 2015 |
| Restaurant sales | 100.0% | 100.0% |
| Costs and expenses: | | |
| Cost of sales | 26.7 | 27.6 |
| Labor | 35.9 | 34.7 |
| Occupancy | 8.3 | 7.2 |
| Restaurant operating expenses | 14.4 | 14.0 |
| General and administrative | 9.0 | 10.0 |
| Preopening expenses | 1.8 | 2.5 |
| Depreciation and amortization | 7.9 | 6.7 |
| Total costs and expenses | 104.0 | 102.7 |
| Income (loss) from operations | (4.0) | (2.7) |
| Interest expense, net | 0.1 | 0.1 |
| Income (loss) before income taxes | (4.2) | (2.9) |
| Income tax expense (benefit) | 0.1 | (0.0) |
| Net income (loss) | (4.2)% | (2.8)% |

Certain amounts may not sum due to rounding.

Three Months Ended March 31, 2016 Compared with Three Months Ended March 31, 2015

Restaurant Sales. Restaurant sales increased \$6.5 million, or 19.7%, to \$39.3 million during the first quarter of 2016 from \$32.8 million in the first quarter of 2015, primarily attributable to a 21.9% increase in the number of operating weeks. Our same-store sales increased 3.6% year over year, driven primarily by average check growth resulting from menu price increases in October 2015 and March 2016, favorable menu mix and a slight increase in traffic. The 3.6% same-store sales growth in the first quarter of 2016 compares to a 2.2% increase in same-store sales in the first quarter of 2015.

Cost of Sales. Cost of sales increased \$1.4 million, or 15.9%, to \$10.5 million in the first quarter of 2016 compared to \$9.1 million in the same prior year period, with the increase primarily attributable to our new locations opened since the beginning of the second quarter of 2015. As a percentage of restaurant sales, cost of sales was 26.7% compared to 27.6% in prior year, primarily reflecting improved kitchen efficiencies for both existing and new units as well as favorable commodity pricing on chicken, ground beef and certain produce.

Labor. Labor expense for our restaurants increased \$2.7 million, or 24.0%, to \$14.1 million in the first quarter of 2016 from \$11.4 million in the first quarter of 2015. Labor expenses as a percentage of restaurant sales increased to 35.9% compared to 34.7% in the prior year period, reflecting labor inefficiencies from our newly opened locations and higher wages and increased overtime hours associated with staffing shortages from a tight labor market. We expect labor cost as a percentage of sales to typically trend higher upon opening and gradually improve as our new restaurant management and employees become more efficient in operating their restaurants.

Occupancy. Occupancy expenses increased \$0.9 million, or 37.8%, to \$3.2 million in the first quarter of 2016 from \$2.4 million in the prior year same quarter, primarily associated with base rent and common area maintenance charges for new locations opened since the beginning of the second quarter of 2015. Occupancy expenses as a percentage of restaurant sales were 8.3% in the first quarter of 2016, compared to 7.2% in the first quarter of 2015.

Restaurant Operating Expenses. Restaurant operating expenses increased \$1.0 million, or 22.4%, to \$5.6 million in the first quarter of 2016 compared to \$4.6 million in the first quarter of 2015, primarily due to the additional operating expenses for the new restaurants opened since the beginning of the second quarter of 2015. Restaurant operating expenses as a percentage of restaurant sales were 14.4% and 14.0% in the first quarter of 2016 and 2015, respectively. The year over year increase was driven by bank and credit card fees, training-related travel costs, repair and maintenance and personal property tax and insurance.

General and Administrative. General and administrative expenses increased by \$0.2 million, or 7.1%, to \$3.5 million from \$3.3 million year over year. Increased payroll, benefit costs and recruiting fees associated with additional headcount investment to support our unit growth expansion and higher legal and professional fees associated with the signing of two international development agreements contributed to the year over year increase in absolute dollars. As a percentage of sales, general and administrative expenses decreased to 9.0% in the first quarter of 2016, compared to 10.0% in the prior year same quarter.

Preopening Expenses. Preopening expenses were \$0.7 million and \$0.8 million in the first quarters of 2016 and 2015, respectively. Preopening expenses during the first quarter of 2016 primarily related to our Irvine, California restaurant opened in April 2016, our Fairfax, Virginia and Minnetonka, Minnesota restaurants scheduled to open in the later part of the second quarter of 2016 and other planned new restaurants for the remainder of 2016. Preopening expenses in the first quarter of 2015 was primarily attributable to the San Juan, Puerto Rico restaurant opened in March 2015 and the Plano, Texas and Arlington, Virginia restaurants opened in the second quarter of 2015.

Depreciation and Amortization. Depreciation and amortization expense increased \$0.9 million, or 42.9%, to \$3.1 million from \$2.2 million year over year. Depreciation and amortization expense as a percentage of restaurant sales was 7.9% and 6.7% of restaurant sales in the first quarter of 2016 and 2015, respectively. The increase was primarily attributable to the new restaurants opened since the beginning of the second quarter of 2015 partially offsetting the impact of fully depreciated assets in the first quarter of 2016 and accelerated depreciation expense from our Denver, Colorado restaurant remodel in 2015.

Interest Expense, Net. Net interest expense is attributable to the amortization of deferred loan fees, the commitment fees associated with the KeyBank credit facility and interest incurred on borrowings under the credit facility partially offset by interest income earned from cash and cash equivalents and investment balances. Interest expense increased year over year as we borrowed \$5.0 million under the credit facility during the first quarter of 2016.

Income Tax Expense (Benefit). Income tax expense was \$25,000 during the first quarter of 2016 compared to an income tax benefit of \$12,000 during the first quarter of 2015. The income tax expense for the first quarter of 2016 consists of state income tax expenses for which no net operating losses or other credits exist. The income tax benefit for the first quarter of 2015 relates to refunds of \$27,000 primarily associated with prior year federal income tax partially offset by state income tax expense of \$15,000 for which no net operating loss carryforwards or other credits

exist.

Potential Fluctuations in Quarterly Results and Seasonality

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

- timing of new restaurant openings and related expenses;
- fluctuations in commodity and food protein prices;
- preopening costs for our newly-opened restaurants and operating costs for those locations, which are often materially greater during the first several months of operation than thereafter;
- timing of restaurant remodels and potential lost sales or additional expenses associated with remodel closures;
- 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;
- settlements, damages and legal costs associated with litigation;
- new or revised regulatory requirements and accounting pronouncements; and
- changes in consumer preferences and competitive conditions.

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

Liquidity and Capital Resources

Currently, our primary capital requirements are for new restaurant development and remodeling of existing restaurants. Similar to many restaurant companies, we utilize operating lease arrangements for all of our restaurant locations. We believe that our operating lease arrangements provide appropriate leverage for our capital structure in a financially efficient manner. We are typically required to expend cash for leasehold improvements, furniture, fixtures and equipment to construct and equip each restaurant. We also require capital resources to maintain our existing base of restaurants, including remodeling, 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):

| | March 31, 2016 | December 31, 2015 |
|---------------------------------|-------------------------------|----------------------------------|
| Cash and short-term investments | \$3,631 | \$ 9,233 |
| Net working capital | \$(10,951) | \$ (5,466) |

| | Three Months Ended March 31, 2016 | | 2015 |
|---------------------------------------|--|---------|-------------|
| Cash provided by operating activities | \$2,841 | \$1,586 | |
| Capital expenditures | \$12,551 | \$6,561 | |

Future Capital Requirements

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

We plan to continue growing organically through unit expansion, with a goal of 20% unit growth annually over the next several years. We achieved a unit growth rate of 23% for 2015, with seven openings during the year. We are working diligently on our real estate pipeline and plan to open eight restaurants and remodel certain restaurants during 2016. We expect to spend approximately \$33 million to \$35 million in capital expenditures in 2016, net of tenant improvement allowances, for the planned construction and remodel of these restaurants.

As of March 31, 2016, we had a working capital deficit of \$11.0 million and borrowings under our credit facility of \$5.0 million. We believe existing cash and short-term investments of \$3.6 million, the ability to draw up to an additional \$30 million on our credit facility and cash flow from operations will be sufficient to fund property additions for new restaurants and planned remodels of existing restaurants during 2016.

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

Debt and Credit Agreements

On April 19, 2013, we entered into a Credit Agreement for a \$20 million revolving line of credit maturing on April 19, 2017 with KeyBank National Association (“KeyBank”) and Stearns Bank National Association (“Stearns Bank”). On November 7, 2014, we entered into an Amended and Restated Credit Agreement (the “Amended Credit Agreement”) with KeyBank to (i) increase the credit facility from \$20 million to \$35 million, and (ii) extend the maturity date of the credit facility to November 7, 2019. The credit facility is secured by our personal property and assets. Certain of our wholly owned subsidiaries have also guaranteed the credit facility. We had \$5 million in outstanding borrowings and \$30 million available under the credit facility at March 31, 2016. In April 2016, we borrowed another \$4 million under the credit facility. We may from time to time request that the total revolving credit commitment be increased up to an amount not to exceed \$60 million. Any such increase is subject to agreement of the respective lenders in the lending syndicate or new lenders in certain circumstances. Any such increase, which may be for a lesser amount than requested by us, is also subject to certain other terms and conditions as provided in the Amended Credit Agreement.

The interest rate under the Amended Credit Agreement is KeyBank’s prime rate or LIBOR, at our option, plus an applicable margin depending on our leverage ratio. The LIBOR margins range from 1.5% to 2.5% and the base rate margins range from 0.5% to 1.5%. Payments on the credit facility are interest only, payable quarterly with respect to each base rate loan and at varying times with respect to LIBOR rate loans, with outstanding principal and interest due at maturity. Prepayment is permitted at any time without penalty, subject to certain restrictions on the order of

repayment or prepayment. We are obligated to pay a commitment fee at an annual rate of 0.175% to 0.350%, depending on our leverage ratio, times the unused total revolving commitment of the credit facility based on the average daily amount outstanding under the credit facility for the previous quarter. The commitment fee is payable quarterly in arrears.

We incurred gross interest expense of \$53,000 and \$45,000 during the quarter ended March 31, 2016 and 2015, consisting primarily of loan fee amortization of \$21,000 and \$20,000, respectively, and commitment fees of \$26,000 and \$22,000, respectively. Unamortized loan fees of \$301,000 at March 31, 2016 are being amortized over the life of the credit facility and are included in other assets in the consolidated balance sheet. Capitalized interest was immaterial for the quarter ended March 31, 2016 and none for the quarter ended March 31, 2015, respectively.

We generally use available cash to repay any borrowings under the credit facility and any remaining balances are maintained by extending the maturities of the borrowings. Our current projections indicate that we will maintain the outstanding borrowings for the next 12 months and, as a result, all borrowings under the credit facility are classified as long-term debt.

The credit facility also requires us to comply with certain covenants, including (a) a fixed charge coverage ratio of not less than 1.50 and (b) a maximum leverage ratio of 5.0 to 1.0 through March 31, 2016 and 4.75 to 1.0 from April 1, 2016 through the maturity date. We were in compliance with all covenants at March 31, 2016.

Cash Flows

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

| | Three Months Ended March 31, | |
|---|---|-------------|
| | 2016 | 2015 |
| Net cash provided by (used in): | | |
| Operating activities | \$2,841 | \$1,586 |
| Investing activities | (12,570) | (6,624) |
| Financing activities | 4,127 | 458 |
| Net change in cash and cash equivalents | \$(5,602) | \$(4,580) |

Operating Activities. Our cash flows from operating activities provided \$2.8 million and \$1.6 million of net cash during the first three months of 2016 and 2015, respectively. The year over year change in cash from operating activities is primarily due to lower net income, timing of payments and receipt of tenant allowance reimbursements and timing of payments for accrued expenses during the first quarter of 2016.

Investing Activities. Capital expenditures for the first quarter of 2016 were \$12.6 million, primarily associated with our Las Vegas restaurant remodel opened during the quarter, costs associated with our Irvine, California restaurant opened in April 2016, and our Fairfax, Virginia and Minnetonka, Minnesota restaurants scheduled to open in the later part of the second quarter of 2016, residual payments from restaurants opened during the fourth quarter of 2015 as well as architecture and design costs associated with our other planned new restaurants and remodels for the remainder of 2016. Capital expenditures for the first quarter of 2015 were \$6.6 million, primarily associated with our San Juan, Puerto Rico restaurant opened in March of 2015, costs associated with our Plano, Texas and Arlington, Virginia restaurants opened in the second quarter of 2015 as well as architecture and design costs associated with our other new restaurants and remodels that were planned for the remainder of 2015.

Financing Activities. Net cash provided by financing activities during the first quarter of 2016 consisted of \$5.0 million of borrowings under our credit facility and \$0.1 million of proceeds from stock option exercises, partially offset by \$1.0 million cash outflow for the repurchase of our common stock. Net cash provided by financing activities during the first quarter of 2015 consisted primarily of proceeds from stock option exercises.

Off-Balance Sheet Arrangements

As of March 31, 2016, we had no off-balance sheet arrangements or obligations.

Critical Accounting Policies and Estimates

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Commodity Price Risk

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

Inflation

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

Interest Rate Risk

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

Item 4. Controls and Procedures

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

As of March 31, 2016, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

There were no changes during the three months ended March 31, 2016 in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

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

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

Item 1A. Risk Factors

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

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

Issuer Purchase of Equity Securities

In November 2015, our Board of Directors authorized a repurchase program of up to \$10.0 million of our outstanding common stock. As of March 31, 2016, we have repurchased and retired \$1.2 million or 98,600 shares under the 2015 authorization, including \$1.0 million or 80,406 shares during the first quarter of 2016.

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plan | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plan |
|---------------|---|---|--|--|
| February 2016 | 23,233 | \$ 12.45 | 23,233 | \$ 9,484,000 |
| March 2016 | 57,173 | \$ 12.16 | 57,173 | \$ 8,789,000 |
| Total | 80,406 | \$ 12.24 | 80,406 | |

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits

Exhibit Number Exhibit

| | |
|------|--|
| 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 |

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

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Kona Grill, Inc.

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

/s/ Christi Hing
Christi Hing
*Chief Financial Officer
(Principal Accounting and Financial
Officer)*

Date: May 5, 2016