

KONA GRILL INC
Form 10-Q
August 02, 2017

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 June 30, 2017

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 **20-0216690**
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

15059 North Scottsdale Road, Suite 300

Scottsdale, Arizona 85254

(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 |
| Emerging growth company | |

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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 July 31, 2017, there were 10,102,027 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)**

| | June 30, 2017 (Unaudited) | December 31, 2016 (Note 1) |
|---|---|--|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 2,593 | \$ 3,476 |
| Short-term investments | 178 | 178 |
| Receivables | 2,483 | 1,850 |
| Inventory | 1,949 | 2,176 |
| Prepaid expenses and other current assets | 810 | 1,052 |
| Total current assets | 8,013 | 8,732 |
| Other assets | 1,059 | 1,383 |
| | 97,577 | 98,268 |
| Property and equipment, net | | |
| Total assets | \$ 106,649 | \$ 108,383 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 3,344 | \$ 4,115 |
| Accrued expenses | 12,719 | 14,450 |
| Current portion of long-term debt | 703 | 712 |
| Total current liabilities | 16,766 | 19,277 |
| Long term debt | 36,380 | 25,921 |
| Deferred rent and other long term liabilities | 32,476 | 31,610 |
| Total liabilities | 85,622 | 76,808 |
| Commitments and contingencies (Note 10) | | |
| Stockholders' equity: | | |
| Preferred stock, \$0.01 par value, 2,000,000 shares authorized, none issued | — | — |
| | 102 | 106 |

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Common stock, \$0.01 par value, 30,000,000 shares authorized, 10,218,827 shares issued and 10,102,027 shares outstanding at June 30, 2017; 10,568,230 shares issued and 10,452,030 shares outstanding at December 31, 2016

| | | |
|--|------------|------------|
| Additional paid-in capital | 85,859 | 88,703 |
| Accumulated deficit | (63,934) | (56,234) |
| Treasury stock, at cost, 116,200 shares at June 30, 2017 and December 31, 2016 | (1,000) | (1,000) |
| Total stockholders' equity | 21,027 | 31,575 |
| Total liabilities and stockholders' equity | \$ 106,649 | \$ 108,383 |

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 June 30, | | Six Months Ended June 30, | |
|--|--|-------------|--|-------------|
| | 2017 | 2016 | 2017 | 2016 |
| Restaurant sales | \$46,977 | \$43,296 | \$92,202 | \$82,573 |
| Costs and expenses: | | | | |
| Cost of sales | 12,996 | 11,213 | 25,549 | 21,714 |
| Labor | 17,104 | 15,479 | 33,829 | 29,597 |
| Occupancy | 4,201 | 3,258 | 8,281 | 6,507 |
| Restaurant operating expenses | 7,532 | 6,065 | 14,815 | 11,704 |
| General and administrative | 3,084 | 3,337 | 6,716 | 6,853 |
| Preopening expenses | 461 | 1,302 | 797 | 2,013 |
| Depreciation and amortization | 3,637 | 3,380 | 7,295 | 6,501 |
| Lease termination and exit costs | 1,384 | — | 1,384 | — |
| Total costs and expenses | 50,399 | 44,034 | 98,666 | 84,889 |
| Income (loss) from operations | (3,422) | (738) | (6,464) | (2,316) |
| Write-off of deferred financing costs | 472 | — | 472 | — |
| Interest expense, net | 408 | 72 | 714 | 125 |
| Income (loss) before income taxes | (4,302) | (810) | (7,650) | (2,441) |
| Income tax expense | 25 | 25 | 50 | 50 |
| Net income (loss) | \$(4,327) | \$(835) | \$(7,700) | \$(2,491) |
| Net income (loss) per share: | | | | |
| Basic | \$(0.43) | \$(0.08) | \$(0.76) | \$(0.22) |
| Diluted | \$(0.43) | \$(0.08) | \$(0.76) | \$(0.22) |
| Weighted average shares used in computation: | | | | |
| Basic | 10,099 | 10,932 | 10,138 | 11,095 |
| Diluted | 10,099 | 10,932 | 10,138 | 11,095 |
| Comprehensive income (loss) | \$(4,327) | \$(835) | \$(7,700) | \$(2,491) |

See accompanying notes to condensed consolidated financial statements.

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

| | Six Months Ended | |
|---|-------------------------|-------------|
| | June 30, | |
| | 2017 | 2016 |
| Operating activities | | |
| Net income (loss) | \$(7,700) | \$(2,491) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Depreciation and amortization | 7,295 | 6,501 |
| Stock-based compensation | 482 | 623 |
| Amortization of deferred financing costs | 84 | 41 |
| Write-off of deferred financing costs | 472 | — |
| Lease termination and exit costs | 1,384 | — |
| Change in operating assets and liabilities: | | |
| Receivables | (633) | (604) |
| Inventory | 227 | (99) |
| Prepaid expenses and other current assets | 287 | 141 |
| Accounts payable | 39 | 99 |
| Accrued expenses | (2,249) | 51 |
| Deferred rent and other long term liabilities | 1,376 | 4,554 |
| Net cash provided by operating activities | 1,064 | 8,816 |
| Investing activities | | |
| Purchase of property and equipment | (8,789) | (22,538) |
| Change in other assets | (52) | (19) |
| Net cash used in investing activities | (8,841) | (22,557) |
| Financing activities | | |
| Borrowings from revolving credit facility | 12,500 | 18,000 |
| Repayments on revolving credit facility | (1,750) | — |
| Repayments on term loan | (375) | — |
| Fees paid for credit facility | (151) | — |
| Purchase and retirement of common stock | (3,572) | (9,773) |
| Proceeds from issuance of common stock under the Employee Stock Purchase Plan and exercise of stock options | 242 | 147 |
| Net cash provided by financing activities | 6,894 | 8,374 |
| Net change in cash and cash equivalents | (883) | (5,367) |
| Cash and cash equivalents at the beginning of the period | 3,476 | 9,055 |

| | | |
|---|---------|---------|
| Cash and cash equivalents at the end of the period | \$2,593 | \$3,688 |
| Supplemental disclosure of cash flow information | | |
| Cash paid for interest, net of capitalized interest | \$732 | \$62 |
| Cash paid for income taxes, net of refunds | \$74 | \$25 |
| Noncash investing activities | | |
| Accounts payable and accruals related to property and equipment | \$1,918 | \$4,544 |

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”) owns and operates upscale casual dining restaurants under the name “Kona Grill.” Our restaurants feature a diverse selection of contemporary American favorites and award-winning sushi items that are prepared fresh daily at each restaurant location. As of June 30, 2017, we owned and operated 46 restaurants in 23 states throughout the United States and Puerto Rico. Our chief operating decision maker function is comprised of our Chief Executive Officer and Chief Financial Officer who manage our restaurant operation base that aggregates into one reportable segment. Accordingly, we have a single operating segment and reporting unit structure.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“U.S. GAAP”) for interim financial information and with the rules and regulations of the U.S. Securities and Exchange Commission (“SEC”). Accordingly, they do not include all of the information and notes required by U.S. GAAP for complete financial statements. In our opinion, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2017 are not necessarily indicative of the results that may be expected for the year ending December 31, 2017.

The consolidated balance sheet at December 31, 2016 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, 2016.

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.

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. We are currently performing an assessment of the revised standard and impacts on the Company’s consolidated financial statements and disclosures. To date, we have reviewed a sample of contracts that are representative of the current types of revenue generating streams. We are still in the process of completing our assessment of the impacts, including the potential impacts on variable consideration on royalty income received from franchise sales.

We anticipate adopting the new standard effective January 1, 2018. The guidance may be applied retrospectively for all periods presented or retrospectively with the cumulative effect of initially applying the guidance recognized at the date of initial application. We currently anticipate adopting the standard retrospectively with the cumulative effect of initially applying the amended guidance recognized at January 1, 2018.

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

In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation (Topic 718) which simplifies the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. The standard is effective for fiscal years beginning after December 15, 2016. The Company has adopted this standard effective January 1, 2017. Under the new standard, income tax benefits and deficiencies are to be recognized as income tax expense or benefit in the income statement and the tax effects of exercised or vested awards should be treated as discrete items in the reporting period in which they occur. The Company should also recognize excess tax benefits regardless of whether the benefit reduces taxes payable in the current period. Excess tax benefits should be classified along with other income tax cash flows as an operating activity. In regards to forfeitures, the Company has elected to not change its accounting policy and continue to estimate the number of awards that are expected to vest. The adoption of this standard created an additional \$2.1 million in deferred tax assets, which was offset by the Company's full valuation allowance. As such, we determined the adoption of this standard did not have a material impact on our consolidated financial position and results of operations. See Note 7 for further discussion.

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.

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

| | Three Months Ended | | Six Months Ended | |
|---------------------------------------|-------------------------------|-------------|-----------------------------|-------------|
| | June 30, 2017 | 2016 | June 30, 2017 | 2016 |
| (In thousands, except per share data) | | | | |
| Numerator: | | | | |
| Net income (loss) | \$ (4,327) | \$ (835) | \$ (7,700) | \$ (2,491) |
| Denominator: | | | | |
| Weighted average shares — Basic | 10,099 | 10,932 | 10,138 | 11,095 |
| Effect of dilutive stock options | — | — | — | — |
| Weighted average shares — Diluted | 10,099 | 10,932 | 10,138 | 11,095 |
| Net income (loss) per share: | | | | |
| Basic | \$ (0.43) | \$ (0.08) | \$ (0.76) | \$ (0.22) |
| Diluted | \$ (0.43) | \$ (0.08) | \$ (0.76) | \$ (0.22) |

Stock options outstanding that were not included in the dilutive earnings per share calculation because the effect would have been anti-dilutive were 1.1 million for the three and six months ended June 30, 2017 and 0.8 million for the three and six months ended June 30, 2016, respectively.

4. Property and Equipment

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

| | June 30, 2017 | December 31, 2016 |
|--|--------------------------|----------------------------------|
| Leasehold improvements | \$ 121,999 | \$ 115,902 |
| Equipment | 31,161 | 29,900 |
| Furniture and fixtures | 12,865 | 12,196 |
| | 166,025 | 157,998 |
| Less accumulated depreciation and amortization | (70,216) | (62,921) |
| | 95,809 | 95,077 |
| Construction in progress | 1,768 | 3,191 |
| Total property and equipment, net | \$ 97,577 | \$ 98,268 |

We capitalize direct internal payroll and travel costs on the construction of leasehold improvements incurred during the development and construction period. Capitalized costs were \$0.2 million and \$0.4 million in the three months ended June 30, 2017 and 2016, respectively, and \$0.5 million and \$0.6 million in the six months ended June 30, 2017 and 2016, respectively.

During the quarter ended June 30, 2017, we wrote-off \$0.8 million of long-lived assets associated with our decision not to open a restaurant in El Segundo. This asset impairment charge is reflected within "Lease termination and exit costs" in the accompanying condensed consolidated statement of comprehensive income (loss). See Note 11 for further discussion.

During the quarter ended December 31, 2016, we recorded non-cash asset impairment charges of \$12.5 million for certain underperforming restaurants based upon an assessment of each restaurant's historical operating performance combined with expected cash flows for these restaurants over the respective remaining lease term. We reduced the carrying value of these assets to their estimated fair value, which was determined using a discounted cash flow model or the market value of each restaurant's assets. While we believe that our estimates of fair value are appropriate, we will continue to monitor the asset values of each individual restaurant. Additionally, should actual values differ materially from our estimates, we may be required to record impairment charges in the future.

5. Accrued Expenses

Accrued expenses consisted of the following (in thousands):

| | June 30, 2017 | December 31, 2016 |
|-------------------------------------|------------------------------|----------------------------------|
| Accrued payroll and benefits | \$3,873 | \$ 4,549 |
| Gift cards | 3,062 | 4,311 |
| Accrued construction ⁽¹⁾ | 1,475 | 2,005 |
| Sales and use taxes | 1,320 | 1,776 |
| Lease termination ⁽²⁾ | 1,048 | — |
| Business and income taxes | 500 | 563 |
| Accrued occupancy | 145 | 240 |
| Other | 1,296 | 1,006 |
| | \$12,719 | \$ 14,450 |

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

(2) Balance is attributable to lease termination costs associated with the decision not to open a restaurant in El Segundo, California. See Note 11.

6. Debt and Credit Agreements

On October 12, 2016, we entered into the Second Amended and Restated Credit Agreement (the “Second Amended Credit Agreement”) with KeyBank National Association (“KeyBank”) and Zions First National Bank to (i) increase the combined revolving and term credit facilities (the “Credit Facility”) from \$35 million to \$60 million, comprised of a \$45 million revolver (“Revolver”) and \$15 million term loan (“Term Loan”), and (ii) extend the maturity date of the Credit Facility to October 12, 2021. On March 29, 2017, we entered into Amendment No. 1 to the Second Amended and Restated Credit Agreement (the “Amendment No.1”). The Amendment No.1 amended the Second Amended Credit Agreement.

On July 7, 2017, we entered into Amendment No. 2 to the Second Amended and Restated Credit Agreement (the “Amendment No. 2”). Amendment No. 2 amends the Second Amended Credit Agreement to, among other things, decrease the total available credit from the Revolver from \$45 million to \$30 million, which including the \$15 million Term Loan, results in an overall reduction of the Credit Facility from \$60 million to \$45 million. Additionally, the maturity date is amended from (a) October 12, 2021 to October 12, 2019, provided that if the Company’s *pro forma* leverage ratio is less than 4.25 to 1.00 at any time prior to the maturity date, the Company may request a one year extension of the maturity date until October 12, 2020; (b) increases the applicable margins for base rate loans and the applicable margins for LIBOR rate loans by 25 bps to 75 bps depending on the Company’s leverage ratio; and (c) increases the maximum leverage ratio and decrease the minimum fixed charge coverage ratio to provide increased

flexibility as further described below. The terms of the Amendment No. 2 were effective as of June 30, 2017. The Credit Facility is secured by our personal property and assets. Certain of our wholly owned subsidiaries have also guaranteed the Credit Facility.

| | June 30, 2017 | | December 31, 2016 | | |
|---|----------------------|-------------------|--------------------------|-----------------|-----------|
| | Unamortized | | | | |
| Maturity | Deferred | Fair Value | Carrying | Carrying | |
| Date | Financing | of Debt | Value of | Value of | |
| | Costs | (b) | Debt | Debt | |
| | (a) | | | | |
| Revolver | Oct. 2019 | \$209 | \$22,750 | \$ 22,750 | \$ 12,000 |
| Term Loan | Oct. 2019 | 105 | 14,438 | 14,438 | 14,813 |
| Total debt | | \$314 | \$37,188 | 37,188 | 26,813 |
| Debt issuance costs presented with debt (a) | | | | (105) | (180) |
| Total debt, net | | | | 37,083 | 26,633 |
| Less: current portion | | | | 703 | 712 |
| Long term debt | | | | \$ 36,380 | \$ 25,921 |

- We have presented the deferred financing costs associated with the Term Loan in the balance sheet as a direct deduction from the carrying amount of the debt liability as of June 30, 2017 and December 31, 2016. The deferred financing costs related to the Revolver continue to be presented as an asset, and are included in both Prepaid (a) expenses and other current assets and Other assets on the condensed consolidated balance sheets as of June 30, 2017 and December 31, 2016. In connection with Amendment No. 2 the Company wrote-off unamortized deferred financing costs associated with both its amended Revolver and Term Loan of approximately \$0.4 million and \$0.1 million, respectively, during the three months ended June 30, 2017.
- (b) Our Revolver and Term Loan bear interest at rates commensurate with market rates and therefore their respective carrying values approximate fair value.

The interest rate under Amendment No. 2 is KeyBank's base rate or LIBOR, at our option, plus an applicable margin depending on our leverage ratio. The LIBOR margins range from 2.00% to 4.00% and the base rate margins range from 1.00% to 3.00%. For such times when the leverage ratio is greater than or equal to 4.75, then the applicable margin for base rate loans and the applicable margin for LIBOR rate loans will be 3.00% and 4.00%, respectively. Payments on the Term Loan are due quarterly and are subject to acceleration upon certain events as defined in the Second Amended Credit Agreement, while borrowings on the Revolver are interest only, payable quarterly with respect to each base rate loan and at varying times with respect to LIBOR rate loans, with outstanding principal and interest due at maturity. Prepayment is permitted at any time without penalty, subject to certain restrictions on the order of repayment or prepayment. We are obligated to pay a commitment fee at an annual rate of 0.175% to 0.350%, depending on our leverage ratio, times the unused total revolving commitment of the Credit Facility based on the average daily amount outstanding under the Credit Facility for the previous quarter. For such times when the leverage ratio is greater than 4.25, the commitment fee annual rate will be 0.50%. The commitment fee is payable quarterly in arrears.

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We incurred gross interest expense of \$0.5 million and \$0.1 million during the quarter ended June 30, 2017 and 2016. Capitalized interest was \$46,000, and \$56,000 for the three months ended June 30, 2017 and 2016, respectively. Gross interest expense of \$0.8 million and \$0.2 million was recorded during the six months ended June 30, 2017 and 2016, respectively. Capitalized interest was \$96,000, and \$56,000 for the six months ended June 30, 2017 and 2016.

At June 30, 2017, we had \$37.2 million in outstanding borrowings, consisting of \$22.8 million under the Revolver and \$14.4 million under the Term Loan. As of June 30, 2017, net availability under the Credit Facility was \$7.25 million, subject to compliance with certain covenants.

Our current projections indicate that we will maintain the outstanding borrowings for the next 12 months and, thus, all borrowings under the Credit Facility are classified as long-term debt, except for the quarterly amortization payments for the Term Loan, which are classified as current portion of long term debt.

Amendment No. 2 requires us to comply with certain covenants on a quarterly basis, including (a) a minimum fixed charge coverage ratio of (i) 1.25 to 1.00 for the fiscal quarter ended June 30, 2017; (ii) 1.20 to 1.00 for the fiscal quarters ended September 30, 2017, December 31, 2017, March 31, 2018, June 30, 2018, September 30, 2018, and December 31, 2018; and (iii) 1.30 to 1.00 for the fiscal quarter ended March 31, 2019 and each fiscal quarter thereafter; and (b) a maximum leverage ratio of (i) 5.50 to 1.00 for the fiscal quarters ended June 30, 2017, September 30, 2017, and December 31, 2017; (ii) 5.25 to 1.00 for the fiscal quarters ended March 31, 2018, June 30, 2018, September 30, 2018 and December 31, 2018; and (iii) 5.00 to 1.00 for the fiscal quarter ended March 31, 2019 and each fiscal quarter thereafter. Under the amended terms of the Credit Facility we were in compliance with such covenants at June 30, 2017.

7. Income Taxes

We recorded an income tax expense of \$25,000 during the three months ended June 30, 2017 and 2016, respectively and \$50,000 during the six months ended June 30, 2017 and 2016, respectively. The income tax expense for the three and six months ended June 30, 2017 and 2016, consists of state income tax expenses for which no net operating losses or other credits exist.

At June 30, 2017, we had approximately \$33.2 million in deferred tax assets primarily related to state net operating loss carryforwards and federal business tax credit carryforwards. Included in this number, the Company recorded the effect of the adoption of ASU 2016-09 as of January 1, 2017, which resulted in an increase to deferred tax assets of approximately \$2.1 million. 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.

8. Stock-Based Compensation

The fair value of stock options granted during the six months ended June 30, 2017 and 2016 was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

**Six Months
Ended June
30,**

2017 2016

| | | |
|--|--------|--------|
| Expected volatility | 50.8% | 45.2% |
| Risk-free interest rate | 1.6 % | 0.9 % |
| Expected option life (in years) | 3.5 | 3.2 |
| Dividend yield | 0.0 % | 0.0 % |
| Weighted average fair value per option granted | \$3.11 | \$4.57 |

The following table summarizes our stock option activity for the three months ended June 30, 2017:

| | Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (years) | Aggregate Intrinsic Value |
|--|----------------|--|--|--|
| Outstanding options at December 31, 2016 | 974,200 | \$ 16.44 | | |
| Granted | 219,178 | 8.15 | | |
| Forfeited | (72,441) | 14.70 | | |
| Exercised | (40,000) | 5.41 | | |
| Outstanding options at June 30, 2017 | 1,080,937 | \$ 15.28 | 2.8 | \$ — |
| Exercisable at June 30, 2017 | 643,167 | \$ 16.20 | 2.2 | \$ — |

We recognized stock-based compensation expense of \$0.2 million and \$0.3 million in the three months ended June 30, 2017 and 2016, respectively and \$0.5 million and \$0.6 million in the six months ended June 30, 2017 and 2016, respectively. As of June 30, 2017, there was \$1.7 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 2.2 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 June 30, 2017.

9. Stock Purchase and Retirement Program

In October 2016, our Board of Directors authorized a repurchase program of up to \$5.0 million of our outstanding common stock. We completed the \$5 million stock repurchase program in February 2017 with the purchase and retirement of 532,376 shares, including \$3.6 million or 395,586 shares during the first quarter of 2017.

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, we filed a Motion for Summary Judgment requesting judgment in our favor on all claims asserted against us 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. A trial date was scheduled for June 12, 2017. The plaintiff filed for a motion of continuance on June 2, 2017 and the motion was granted. The trial date is now scheduled for July 9, 2018. We believe that we have a strong defense to the claim asserted by the plaintiff and insurance coverage for the claim. As such, we believe any loss associated with this claim is remote and therefore, we have not reserved for any potential future payments.

11. Lease Termination and Exit Costs

As a result of our continued focus on improving sales and margins at our existing restaurants, in addition to slowing growth to provide us with capital allocation flexibility, we made the decision in the second quarter of 2017 to not open a restaurant in El Segundo, California and stopped construction on this restaurant. We recognized \$1.4 million associated with the estimated costs to terminate the lease, asset impairment charges, write-off of deferred rent liability, and other costs associated with this location.

Lease termination and exit costs attributable to the El Segundo restaurant are reflected within “Lease termination and exit costs” in the accompanying condensed consolidated statement of comprehensive income (loss). Such costs consisted of the following:

| | Three Months Ended | | Six Months Ended | |
|--|-----------------------------------|-------------|-----------------------------|-------------|
| | June 30, | | June 30, | |
| | 2017 | 2016 | 2017 | 2016 |
| (In thousands) | | | | |
| Lease termination costs | \$1,048 | \$ — | \$1,048 | \$ — |
| Write-off of deferred rent liability | (510) | — | (510) | — |
| Asset impairment charge | 846 | — | 846 | — |
| Total lease termination and exit costs | \$1,384 | \$ — | \$1,384 | \$ — |

The lease termination and exit cost accrual is included in accrued expenses on the consolidated balance sheets. Activities associated with the lease termination and exit cost accrual are summarized below (in thousands):

| | Lease Exit Costs |
|---|---------------------------------|
| Lease termination and exit costs accrued at January 1, 2017 | \$— |
| Lease termination and exit-related costs | 1,048 |
| Cash payments | — |
| Lease termination and exits costs accrued at June 30, 2017 | \$1,048 |

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, 2016 contained in our 2016 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, 2016 and other reports filed from time to time with the SEC.

Overview

We currently own and operate 46 restaurants located in 23 states and Puerto Rico. Over the past four years, we have grown organically through opening new restaurants. We achieved a unit growth rate of 22% in 2016, with eight openings during the year and 23% unit growth in 2015 with seven restaurant openings. We opened our first and only domestic restaurant this year at the Scottsdale Quarter in Scottsdale, Arizona, and no other domestic openings are planned for the remainder of 2017. We believe that a more modest growth rate will allow us to focus our time and attention on new restaurant operations and performance.

We continue to assess our capital allocation strategy and in the second quarter of 2017 made the decision to not move forward with the planned construction and opening of a restaurant in El Segundo, California. We are in the early stages of negotiations with the landlord in evaluating the costs associated with this decision, including lease termination costs. As such, during the second quarter of 2017, we recognized \$1.4 million related to estimated lease termination and exit costs for the El Segundo restaurant. See "Lease Termination and Exit Costs" in Note 11 of the Notes to the Condensed Consolidated Financial Statements for further discussion.

We continue to seek rent abatements or contemplate restaurant closures for certain underperforming locations as part of our strategy to improve financial performance. During the second quarter of 2017, we executed lease amendments for rent concessions for a one-year period at two of our existing restaurants. We will continue to negotiate with certain of our landlords regarding rent abatement or closures of certain additional restaurants.

We continue to execute our strategy for international market expansion. Given the strength of our concept 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 April 2017, we signed an agreement for the development of one Kona Grill restaurant in Toronto, Canada. The agreement allows our franchisee the right to develop additional restaurants in the Toronto market for a specified period of time following the opening of the first restaurant. In February 2016, we signed an agreement for the development of six Kona Grill restaurants in Mexico and in April 2016, we signed an agreement for the development of six Kona Grill restaurants in the United Arab Emirates. Our three international franchise partners continue to make progress on the development of Kona Grill restaurants outside of the United States. Each of our franchisees is expected to open a Kona Grill restaurant in their respective country during the second half of 2017 with the first location expected to open in Monterrey, Mexico in the third quarter of 2017.

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 up 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 has had, and is expected to continue to have, an impact on cost of sales, labor, occupancy, and restaurant operating expenses measured as a percentage of restaurant sales, 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.

Sales per Square Foot. Sales per square foot is a measure of a restaurant's productivity and represents the amount of sales generated for each square foot.

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.

EBITDA and Adjusted EBITDA. EBITDA is defined as net income (loss) plus the sum of interest, taxes, depreciation and amortization. Adjusted EBITDA is defined as EBITDA plus unusual or non-recurring items, such as impairment, lease termination and exit costs and write-off of deferred financing costs. EBITDA and Adjusted EBITDA are presented because: (i) we believe it is a useful measure for investors to assess the operating performance of our business; (ii) we believe that investors will find these measures useful in assessing our ability to service or incur indebtedness; and (iii) we use EBITDA and Adjusted EBITDA internally as a benchmark to evaluate our operating performance and compare our performance to that of our competitors.

Financial Performance Overview

The following table sets forth certain information regarding our financial performance for the three months ended June 30, 2017 and 2016:

| | Three Months Ended | | Six Months Ended | |
|--|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2017 | 2016 | 2017 | 2016 |
| Restaurant sales growth | 8.5 % | 19.5 % | 11.7 % | 19.6 % |
| Same-store sales percentage change | (5.3)% | 2.5 % | (4.8)% | 3.1 % |
| Average unit volume (in thousands) | \$1,108 | \$1,197 | \$2,166 | \$2,337 |
| Sales per square foot | \$154 | \$166 | \$300 | \$323 |
| Restaurant operating profit (in thousands) | \$5,144 | \$7,281 | \$9,728 | \$13,051 |
| Restaurant operating profit as a percentage of sales | 10.9 % | 16.8 % | 10.6 % | 15.8 % |
| EBITDA (in thousands) | \$(257) | \$2,642 | \$359 | \$4,185 |
| EBITDA as a percentage of sales | (0.5)% | 6.1 % | 0.4 % | 5.1 % |
| Adjusted EBITDA (in thousands) | \$1,599 | \$2,642 | \$2,215 | \$4,185 |
| Adjusted EBITDA as a percentage of sales | 3.4 % | 6.1 % | 2.4 % | 5.1 % |

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

| | Three Months Ended | | Six Months Ended | |
|---------------------------------------|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2017 | 2016 | 2017 | 2016 |
| (In thousands) | | | | |
| Net Income (loss) | \$(4,327) | \$(835) | \$(7,700) | \$(2,491) |
| Income tax expense | 25 | 25 | 50 | 50 |
| Interest expense, net | 408 | 72 | 714 | 125 |
| Depreciation and amortization | 3,637 | 3,380 | 7,295 | 6,501 |
| EBITDA | \$(257) | \$2,642 | \$359 | \$4,185 |
| Lease termination and exit costs | 1,384 | — | 1,384 | — |
| Write-off of deferred financing costs | 472 | — | 472 | — |
| Adjusted EBITDA | \$1,599 | \$2,642 | \$2,215 | \$4,185 |
| General and administrative | 3,084 | 3,337 | 6,716 | 6,853 |
| Preopening expense | 461 | 1,302 | 797 | 2,013 |
| Restaurant operating profit | \$5,144 | \$7,281 | \$9,728 | \$13,051 |

| | Percentage of | | Percentage of | |
|---------------------------------------|----------------------|-------------|----------------------|-------------|
| | Restaurant | | Restaurant | |
| | Sales | | Sales | |
| | Three | | Six Months | |
| | Months | | Ended | |
| | Ended | | | |
| | June 30, | | June 30, | |
| | 2017 | 2016 | 2017 | 2016 |
| Net Income (loss) | (9.2)% | (1.9)% | (8.4)% | (3.0)% |
| Income tax expense | 0.1 | 0.1 | 0.1 | 0.1 |
| Interest expense, net | 0.9 | 0.2 | 0.8 | 0.2 |
| Depreciation and amortization | 7.7 | 7.8 | 7.9 | 7.9 |
| EBITDA | (0.5) | 6.1 | 0.4 | 5.1 |
| Lease termination and exit costs | 2.9 | 0.0 | 1.5 | 0.0 |
| Write-off of deferred financing costs | 1.0 | 0.0 | 0.5 | 0.0 |
| Adjusted EBITDA | 3.4 | 6.1 | 2.4 | 5.1 |
| General and administrative | 6.6 | 7.7 | 7.3 | 8.3 |
| Preopening expense | 1.0 | 3.0 | 0.9 | 2.4 |
| Restaurant operating profit | 10.9% | 16.8% | 10.6% | 15.8% |

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 | | Six Months | |
|-------------------------------|---------------------|-------------|-------------------|-------------|
| | Ended | | Ended | |
| | June 30, | | June 30, | |
| | 2017 | 2016 | 2017 | 2016 |
| Restaurant sales | 100 % | 100 % | 100 % | 100 % |
| Costs and expenses: | | | | |
| Cost of sales | 27.7 | 25.9 | 27.7 | 26.3 |
| Labor | 36.4 | 35.8 | 36.7 | 35.8 |
| Occupancy | 8.9 | 7.5 | 9.0 | 7.9 |
| Restaurant operating expenses | 16.0 | 14.0 | 16.1 | 14.2 |

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| | | | | |
|---------------------------------------|-----------|---------|-----------|-----------|
| General and administrative | 6.6 | 7.7 | 7.3 | 8.3 |
| Preopening expenses | 1.0 | 3.0 | 0.9 | 2.4 |
| Depreciation and amortization | 7.7 | 7.8 | 7.9 | 7.9 |
| Lease termination and exit costs | 2.9 | 0.0 | 1.5 | 0.0 |
| Total costs and expenses | 107.3 | 101.7 | 107.0 | 102.8 |
| Income (loss) from operations | (7.3) | (1.7) | (7.0) | (2.8) |
| Write-off of deferred financing costs | 1.0 | 0.0 | 0.5 | 0.0 |
| Interest expense, net | 0.9 | 0.2 | 0.8 | 0.2 |
| Income (loss) before income taxes | (9.2) | (1.9) | (8.3) | (3.0) |
| Income tax expense | 0.1 | 0.1 | 0.1 | 0.1 |
| Net income (loss) | \$(9.2)% | (1.9)% | \$(8.4)% | \$(3.0)% |

Certain amounts may not sum due to rounding.

Three Months Ended June 30, 2017 Compared with Three Months Ended June 30, 2016

Restaurant Sales. Restaurant sales increased \$3.7 million, or 8.5%, to \$47.0 million during the second quarter of 2017 from \$43.3 million in the second quarter of 2016, primarily attributable to a 18.6% increase in the number of operating weeks. Same-store sales decreased 5.3% in the second quarter of 2017 as compared to a 2.5% increase in the second quarter of last year. The decrease in same-store sales this year reflects a 4.6% decline in guest traffic and unfavorable menu mix partially offset by slightly higher menu prices.

Cost of Sales. Cost of sales increased \$1.8 million, or 15.9%, to \$13.0 million in the second quarter of 2017 compared to \$11.2 million in the prior year period, with the increase primarily attributable to eight new locations opened since June 2016. As a percentage of restaurant sales, cost of sales was 27.7% compared to 25.9% in the prior year, primarily reflecting higher pricing on ground beef, sea bass and certain produce, as well as lower beer margins due to promotional offerings.

Labor. Labor expense for our restaurants increased \$1.6 million, or 10.5%, to \$17.1 million in the second quarter of 2017 from \$15.5 million in the second quarter of 2016. Labor expenses as a percentage of restaurant sales increased to 36.4% compared to 35.8% in the prior year period, reflecting increased wage costs due to certain state mandated minimum wage increases, labor inefficiencies from our newly opened locations, and a competitive labor market resulting in higher wage costs. 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 29.0%, to \$4.2 million in the second quarter of 2017 from \$3.3 million in the prior year same quarter, primarily associated with base rent and common area maintenance charges for eight new locations opened since June 2016. Occupancy expenses as a percentage of restaurant sales were 8.9% in the second quarter of 2017, compared to 7.5% in the second quarter of 2016.

Restaurant Operating Expenses. Restaurant operating expenses increased \$1.5 million, or 24.2%, to \$7.5 million in the second quarter of 2017 compared to \$6.1 million in the second quarter of 2016, primarily due to additional operating expenses for eight new restaurants opened since June 2016. Restaurant operating expenses as a percentage of restaurant sales were 16.0% and 14.0% in the second quarter of 2017 and 2016, respectively. The year over year increase was driven in part by higher delivery service fees and an increase in advertising costs.

General and Administrative. General and administrative expenses decreased by \$0.3 million, or 7.6%, to \$3.1 million from \$3.3 million year over year. Additionally, these expenses decreased as a percentage of sales to 6.6% in the second quarter of 2017 compared to 7.7% in the prior year same quarter primarily attributable to the decrease in

payroll and benefits due to low headcount, as a result of the Company's cost-savings initiatives implemented during the second quarter of 2017 and leverage on a higher sales base.

Preopening Expenses. Preopening expenses were \$0.5 million and \$1.3 million in the second quarter of 2017 and 2016, respectively. Preopening expenses in the second quarter of 2017 was primarily attributable to the Scottsdale Quarter restaurant, which opened in June of 2017. Preopening expenses during the second quarter of 2016 primarily related to our Irvine restaurant opened in April 2016, our Fairfax, Virginia and Minnetonka restaurants opened in the later part of the second quarter of 2016 and other new restaurants that were planned for the remainder of 2016.

Depreciation and Amortization. Depreciation and amortization expense increased \$0.2 million, or 7.6%, to \$3.6 million from \$3.4 million year over year. Depreciation and amortization expense as a percentage of restaurant sales was 7.7% and 7.8% of restaurant sales in the second quarter of 2017 and 2016, respectively. The increase is primarily attributable to eight new restaurants opened since June 2016, partially offset by a lower depreciable asset base as result of the \$12.5 million asset impairment charge recorded in the fourth quarter of 2016.

Lease Termination and Exit Costs. In the second quarter of 2017, we assessed our capital allocation strategy and made the decision to not move forward with the planned construction and opening of a restaurant in El Segundo, California. As such, we recognized \$1.4 million related to estimated lease termination costs and asset write-offs during the three months ended June 30, 2017.

Interest Expense, Net. Net interest expense is attributable to the amortization of deferred loan fees, the commitment fees associated with our credit facility and interest incurred on borrowings under the Credit Facility. Interest expense increased year over year as we had \$37.2 million outstanding under the Credit Facility as of June 30, 2017 compared to borrowings of \$18.0 million in the prior year period.

Write-Off of Deferred Financing Costs. Effective June 30, 2017 we amended our Credit Facility to provide additional flexibility with financial covenants and also decreased our Revolver from \$45 million to \$30 million and shortened the maturity date to October 12, 2019. As a result, we wrote-off a portion of the unamortized deferred financing costs associated with the Amendment of approximately \$0.5 million during the three months ended June 30, 2017.

Income Tax Expense. Income tax expense was \$25,000 for the three months ended June 30, 2017 and 2016, respectively, and consisted of state income tax expenses for which no net operating loss carryforwards or other credits exist.

Six Months Ended June 30, 2017 Compared with Six Months Ended June 30, 2016

Restaurant Sales. Restaurant sales increased 11.7% to \$92.2 million during the first half of 2017 from \$82.6 million in the first half of 2016, primarily due to a 20.6% increase in the number of operating weeks from nine restaurants opened since April 2016. Same store sales decreased 4.8% in the first half of 2017 compared to an increase of 3.1% in the first half of 2016 driven primarily by a decline in customer traffic compared to the prior year period.

Cost of Sales. Cost of sales increased \$3.8 million, or 17.7% to \$25.5 million during the first half of 2017 compared to \$21.7 million during the same period in the prior year, primarily attributable to nine new locations that opened since April 2016. As a percentage of restaurant sales, cost of sales was 27.7% compared to 26.3% during the same prior year period, primarily reflecting unfavorable commodity pricing on seafood and certain produce, and an increase in beer costs as a result of promotions offered at certain locations.

Labor. Labor costs in the first half of 2017 increased \$4.2 million, or 14.3% to \$33.8 million compared to \$29.6 million in the comparable prior year period, mainly due to incremental labor costs for nine new locations opened since

April 2016. Labor expenses as a percentage of restaurant sales increased to 36.7% compared to 35.8% in the prior year period driven mainly by increased wage costs due to certain state mandated minimum wage increases and a competitive labor market.

Occupancy. Occupancy expenses increased \$1.8 million or 27.3% to \$8.3 million in the first half of 2017 compared to \$6.5 million in the prior year period. Higher base rent and common area maintenance charges associated with the new locations accounted for the majority of the total year over year increase. Occupancy expenses as a percentage of restaurant sales were 9.0% in the first half of 2017 compared to 7.9% in the first half of 2016.

Restaurant Operating Expenses. Restaurant operating expenses increased \$3.1 million, or 26.6%, to \$14.8 million during the first half of 2017 compared to \$11.7 million in the same period in 2016, primarily due to incremental operating expenses associated with nine new locations opened since April 2016. Restaurant operating expenses as a percentage of restaurant sales were 16.1% during the first half of 2017 compared to 14.2% in the first half of 2016. The year over year increase was driven primarily by higher advertising costs associated with increased marketing efforts to enhance brand awareness and delivery and service related fees.

General and Administrative. General and administrative expenses decreased by \$0.1 million, or 2.0% to \$6.7 million from \$6.9 million year over year. General and administrative expenses as a percentage of sales decreased to 7.3% in the first half of 2017 compared to 8.3% in the prior year period. Decreased payroll, benefit costs and recruiting fees associated with a reduction in headcount as a result of the slow-down in growth contributed to the year over year decrease in absolute dollars, partially offset by higher advertising fees associated with our increased marketing efforts contributed to the year over year decrease in absolute dollars.

Preopening Expenses. Preopening expenses were \$0.8 million and \$2.0 million in the first half of 2017 and 2016, respectively. Preopening expenses in the first half of 2017 were primarily attributable to the Scottsdale Quarter restaurant, which opened in June 2017. Preopening expenses in year to date 2016 were primarily attributable to the Irvine restaurant, which opened in April 2016, the Fairfax and Minnetonka restaurants, which opened in June 2016 and other planned new restaurant openings for the remainder of 2016.

Depreciation and Amortization. Depreciation and amortization expense increased \$0.8 million or 12.2% to \$7.3 million year over year, primarily attributable to the new restaurants opened since April 2016 partially offset by the impact of certain assets that became fully depreciated in the first half of 2017, and a lower depreciable asset base as a result of the \$12.5 million asset impairment charge recorded in the fourth quarter of 2016. Depreciation and amortization expense as a percentage of restaurant sales was 7.9% in the first half of 2017 and 2016, respectively.

Lease Termination and Exit Costs. In the second quarter of 2017, we assessed our capital allocation strategy and made the decision to not move forward with the planned construction and opening of a restaurant in El Segundo, California. As such, we recognized \$1.4 million related to estimated lease termination costs and asset write-offs during the first half of 2017.

Interest Expense, Net. Interest expense increased year over year due to borrowings under the Credit Facility, with \$37.2 million and \$18.0 million outstanding under the Credit Facility as of the end of the second quarter of 2017 and 2016, respectively. We used the majority of the borrowings to fund new restaurant construction and our stock repurchase program.

Write-Off of Deferred Financing Costs. Effective June 30, 2017 we amended our Credit Facility to provide additional flexibility with financial covenants and also decreased our Revolver from \$45 million to \$30 million and shortened the maturity date to October 12, 2019. As a result, we wrote-off a portion of the unamortized deferred financing costs associated with the Amendment of approximately \$0.5 million during the three and six months ended June 30, 2017.

Income Tax Expense. Income tax expense was \$50,000 during the six months ended June 30, 2017 and 2016, respectively, related to state income tax expenses for which no state 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;
- profitability of our restaurants, especially in new markets;
- preopening costs for our newly-opened restaurants and operating costs for those locations, which are often materially greater during the first several months of operation than thereafter;

timing of restaurant remodels and potential lost sales associated with remodel closure;
labor availability and wages and benefits for hourly and management personnel;
increases and decreases in comparable restaurant sales;
impairment of long-lived assets and any loss on restaurant closures;
costs related to any lease terminations, which could be significant, or fluctuations due to renegotiation of leases;
fluctuations in commodity and food protein prices;
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

Our primary capital requirements are for new restaurant development and maintenance of our 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 and information technology initiatives.

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

| June 30, | December 31, |
|---------------------|-------------------------|
| 2017 | 2016 |

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| | | |
|---------------------------------|-----------|-------------|
| Cash and short-term investments | \$2,771 | \$ 3,654 |
| Net working capital | \$(8,753) | \$(10,545) |

**Six Months
Ended June 30,
2017 2016**

| | | |
|---------------------------------------|----------|----------|
| Cash provided by operating activities | \$ 1,064 | \$8,816 |
| Capital expenditures | \$8,789 | \$22,538 |

Future Capital Requirements

Our capital requirements, including development costs related to the opening of new restaurants, have historically been significant. Over the past year, we funded development of new restaurants and remodels primarily from cash flows from operations 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 opened our first and only domestic restaurant this year at the Scottsdale Quarter, and no other domestic openings are planned for the remainder of 2017. We are focused on building sales, ramping up margins and generating cash flow to repay debt. We spent \$8.8 million of capital expenditures during the six months ended June 30, 2017, primarily associated with the opening of the Scottsdale Quarter restaurant, residual payments for restaurants opened during the second half of 2016, the relocation of our corporate office and maintenance capital expenditures. Additionally, we received \$1.2 million in tenant improvement allowances in the first half of 2017, and expect to collect additional tenant improvement allowances in the second half of 2017. Net capital expenditures was \$7.6 million for the six months ended June 30, 2017. We expect to spend approximately \$7 million to \$9 million in capital expenditures in 2017, net of tenant improvement allowances. We have slowed down our growth of units, and current plans for unit growth are through the franchising of our brand internationally and one domestic restaurant opening in 2018.

As of June 30, 2017, we had a working capital deficit of \$8.8 million and outstanding borrowings under our Credit Facility of \$37.2 million. We believe existing cash and cash equivalents and short-term investments of \$2.8 million, the ability to draw additional borrowings under our Credit Facility, subject to compliance with certain covenants, and cash flow from operations will be sufficient to fund working capital requirements over the next 12 months. However, on July 7, 2017 we entered into Amendment No. 2 to the Second Amended and Restated Credit Agreement described below which, among other things, decreased the total available credit from the Revolver from \$45 million to \$30 million, which including the \$15 million term loan, results in an overall reduction of the Credit Facility from \$60 million to \$45 million.

During the first half of 2017, we repurchased \$3.6 million or 395,586 shares of common stock and completed our \$5.0 million stock repurchase program.

Any reduction of our cash flow from operations or an inability to draw on our Credit Facility may cause a delay or cancellation of future restaurant development or remodels of existing restaurants. Financing to construct new restaurants or remodels for amounts in excess of our current cash and short-term investments and the line of credit availability may not be available on acceptable terms, or at all, and our failure to raise capital when needed could impact our growth plans, financial condition, and results of operations. Additional equity financing, to the extent

available, may result in dilution to current stockholders and additional 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 October 12, 2016, we entered into the Second Amended and Restated Credit Agreement (the “Second Amended Credit Agreement”) with KeyBank National Association (“KeyBank”) and Zions First National Bank to (i) increase the combined revolving and term credit facilities (the “Credit Facility”) from \$35 million to \$60 million, comprised of a \$45 million revolver (“Revolver”) and \$15 million term loan (“Term Loan”), and (ii) extend the maturity date of the Credit Facility to October 12, 2021. On March 29, 2017, we entered into Amendment No. 1 to the Second Amended and Restated Credit Agreement (the “Amendment No.1”). The Amendment No.1 amended the Second Amended Credit Agreement.

On July 7, 2017, we entered into Amendment No. 2 to the Second Amended and Restated Credit Agreement (the “Amendment No.2”). Amendment No. 2 amends the Second Amended Credit Agreement to, among other things, decrease the total available credit from the revolving credit facility from \$45 million to \$30 million, which including the \$15 million term loan, results in an overall reduction of the Credit Facility from \$60 million to \$45 million. Additionally, the maturity date is amended from (a) October 12, 2021 to October 12, 2019, provided that if the Company’s *pro forma* leverage ratio is less than 4.25 to 1.00 at any time prior to the maturity date, the Company may request a one year extension of the maturity date until October 12, 2020; (b) increases the applicable margins for base rate loans and the applicable margins for LIBOR rate loans by 25 bps to 75 bps depending on the Company’s leverage ratio; and (c) increases the maximum leverage ratio and decrease the minimum fixed charge coverage ratio to provide increased flexibility as further described below. The terms of the Amendment No. 2 were effective as of June 30, 2017. The Credit Facility is secured by our personal property and assets. Certain of our wholly owned subsidiaries have also guaranteed the Credit Facility.

Amendment No. 2 requires us to comply with certain covenants on a quarterly basis, including (a) a minimum fixed charge coverage ratio of (i) 1.25 to 1.00 for the fiscal quarter ended June 30, 2017; (ii) 1.20 to 1.00 for the fiscal quarters ended September 30, 2017, December 31, 2017, March 31, 2018, June 30, 2018, September 30, 2018, and December 31, 2018; and (iii) 1.30 to 1.00 for the fiscal quarter ended March 31, 2019 and each fiscal quarter thereafter; and (b) a maximum leverage ratio of (i) 5.50 to 1.00 for the fiscal quarters ended June 30, 2017, September 30, 2017, and December 31, 2017; (ii) 5.25 to 1.00 for the fiscal quarters ended March 31, 2018, June 30, 2018, September 30, 2018 and December 31, 2018; and (iii) 5.00 to 1.00 for the fiscal quarter ended March 31, 2019 and each fiscal quarter thereafter. Under the amended terms of the Credit Facility we were in compliance with such covenants at June 30, 2017.

At June 30, 2017, we had \$37.2 million in outstanding borrowings, consisting of \$22.8 million under the Revolver and \$14.4 million under the Term Loan. As of June 30, 2017, net availability under the Credit Facility was \$7.25 million, subject to compliance with certain covenants.

Cash Flows

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

| | Six Months Ended June 30, 2017 2016 | |
|---|---|------------|
| Net cash provided by (used in): | | |
| Operating activities | \$ 1,064 | \$ 8,816 |
| Investing activities | (8,841) | (22,557) |
| Financing activities | 6,894 | 8,374 |
| Net change in cash and cash equivalents | \$(883) | \$(5,367) |

Operating Activities. Our cash flows from operating activities provided \$1.1 million and \$8.8 million of net cash during the first six months of 2017 and 2016, 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 second quarter of 2017.

Investing Activities. Capital expenditures for the first half of 2017 were \$8.8 million, primarily associated with our Scottsdale Quarter restaurant, which opened in June 2017, residual payments from restaurants opened during the fourth quarter of 2016, and maintenance capital expenditures. Capital expenditures for the first half of 2016 were \$22.5 million, primarily associated with our Las Vegas restaurant remodel in the first quarter, costs associated with our Irvine restaurant opened in April 2016, and our Fairfax and Minnetonka restaurants opened in June 2016, residual

payments from restaurants opened during the fourth quarter of 2015 as well as construction and architecture and design costs associated with our other planned new restaurants and remodels for the remainder of 2016.

Financing Activities. Net cash provided by financing activities during the six months ended June 30, 2017 was \$6.9 million and consisted primarily of \$12.5 million of borrowings and \$0.2 million of proceeds from stock option exercises, partially offset by \$3.6 million for the repurchase of common stock under our October 2016 stock repurchase program, \$2.1 million in payments under our Credit Facility and \$0.2 million for debt issuance costs associated with Amendment No.1 to our Credit Facility. Net cash provided by financing activities during the six months ended June 30, 2016 consisted of \$18.0 million of borrowings under our Credit Facility and \$0.1 million of proceeds from stock option exercises, partially offset by \$9.8 million cash outflow for the repurchase of our common stock.

Off-Balance Sheet Arrangements

As of June 30, 2017, we had no off-balance sheet arrangements or obligations, other than operating leases, which are not classified as debt.

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. Our critical accounting policies and estimates are identified and described in our annual report on Form 10-K for the year ended December 31, 2016.

We had no significant changes in our critical accounting policies and estimates since our last annual report, except for the added disclosure to the revenue recognition policy surrounding breakage income related to our gift card liability. The updated revenue recognition accounting policy is as follows:

Revenue Recognition

Revenues from food, beverage, and alcohol sales are recognized when payment is tendered at the point of sale. Restaurant sales are recorded net of promotions and discounts. Revenues from gift card sales are recognized upon redemption. Prior to redemption, the outstanding balances of all gift cards are included in accrued expenses in the accompanying Condensed Consolidated Balance Sheets. We recognize gift card breakage income when the likelihood of the redemption of the gift cards becomes remote. Gift card breakage income is recorded in "Restaurant Sales" on the Condensed Consolidated Statements of Comprehensive Income (Loss) and amounted to zero and \$0.2 million for the three and six months ended June 30, 2017, respectively. We did not record any breakage income related to our gift card liability for the three and six months ended June 30, 2016.

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 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 two years, inflation has not significantly affected our operating results.

Interest Rate Risk

We also face market risk exposure due to the variable interest rates on our Credit Facility. Interest on both the Term and Revolver loans are 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 June 30, 2017, 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 June 30, 2017 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

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, we filed a Motion for Summary Judgment requesting judgment in our favor on all claims asserted against us 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. A trial date was scheduled for June 12, 2017. The plaintiff filed for a motion of continuance on June 2, 2017 and the motion was granted. The trial date is now scheduled for July 9, 2018. We believe that we have a strong defense to the claim asserted by the plaintiff and insurance coverage for the claim. As such, we believe any loss associated with this claim is remote and therefore, we have not reserved for any potential

future payments.

On July 27, 2017, the Company received a letter from an attorney purporting to represent two stockholders of the Company. The letter relates to a proposal to amend the Company's 2012 Stock Award Plan (the "Plan") that was brought before the Company's shareholders at its 2015 annual stockholders' meeting. The letter claims that although the Plan amendment received affirmative votes from stockholders holding 57.7% of the shares present and entitled to vote on the proposal, it was not duly approved by the appropriate voting standard. The Company is investigating the claims made in such letter and, if warranted, possible corrective action. The Company does not expect that its receipt of the demand letter or the claims made therein will have a materially adverse effect on its financial condition or results of operation. However, the Nasdaq Marketplace Rules require that listed companies obtain stockholder approval prior to issuing securities under equity incentive plans when such plans are established or materially amended. Depending upon the validity of the claims made in the demand letter, Nasdaq may provide us with a deficiency letter and require that we present Nasdaq with a plan of compliance to correct the asserted violation.

Also on July 27, 2017, a class action complaint was filed against Kona Sushi, Inc., a wholly-owned subsidiary of the Company, by Mitchell Boots, individually and on behalf of a Proposed Rule 23 Class, in the United States District Court for Minnesota claiming, among other things, that the Company violated Minnesota gratuity/tip pooling laws with respect to certain classes of restaurant employees. The plaintiff has brought claims on behalf of a putative Minnesota class and a putative national class of employees. The Company is investigating the claims made in such complaint although it does not expect the result of such complaint to have a material adverse effect on the Company.

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, 2016. 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, 2016. These cautionary statements are to be used as a reference in connection with any forward-looking statements. The factors, risks, and uncertainties identified in these cautionary statements are in addition to those contained in any other cautionary statements, written or oral, which may be made or otherwise addressed in connection with a forward-looking statement or contained in any of our subsequent filings with the SEC.

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

Not applicable.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits

| Exhibit Number | Exhibit |
|---------------------------|---|
| 10.1 | <p><u>Amendment No. 2 to Second Amended and Restated Credit Agreement</u> <u>dated as of July 7, 2017</u> <u>(incorporated by reference to Form 8-K filed July 11, 2017).</u></p> |
| 31.1 | <p>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.</p> |
| 31.2 | <p>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.</p> |
| 32.1 | <p>Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of</p> |

32.2 the
Sarbanes-Oxley
Act of 2002.
Certification
pursuant to 18
U.S.C. Section
1350, as
adopted
pursuant to
Section 906 of
the
Sarbanes-Oxley
Act of 2002.
Interactive data
files pursuant to
Rule 405 of
Regulation S-T
(i) the
Condensed
Consolidated
Balance Sheets
as of June 30,
2017 and
December 31,
2016, (ii) the
Unaudited
Condensed
Consolidated
Statements of
Comprehensive
Income (Loss)
101 for the three and
six months
ended June 30,
2017 and 2016,
(iii) the
Unaudited
Condensed
Consolidated
Statements of
Cash Flows for
the six months
ended June 30,
2017 and 2016
and (iv) the
Notes to the
Unaudited
Condensed
Consolidated
Financial
Statements.

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: August 2, 2017