KONA GRILL INC
Form 424B3
April 17, 2009

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Registration No. 333-158278

PROSPECTUS

2,608,125 Shares

Rights to Purchase up to 2,608,125 Shares

Common Stock

Kona Grill, Inc. is conducting a rights offering. We are distributing at no charge rights to purchase shares of our common stock to each person that owned shares of our common stock at the close of business on April 17, 2009. During this rights offering, we may issue up to 2,608,125 shares of common stock. During March 2009, we entered into a note and warrant purchase agreement with certain accredited investors, whom we refer to herein as noteholders, whereby we sold $1.2 million aggregate principal amount of 10% unsecured subordinated notes and warrants to purchase shares of our common stock. As part of the note and warrant purchase agreement, we agreed to commence this rights offering and provide a basic subscription right to each of our stockholders as described herein. The note and warrant purchase agreement further provides that any shares of our common stock that are not subscribed for under the basic subscription rights of such stockholders will be offered to the noteholders on a pro rata basis based on the aggregate principal amount of notes outstanding and at the same subscription price. We refer to this right of over-subscription of the noteholders as the over-subscription privilege.

You will receive one non-transferable subscription right for every 2.5 shares of common stock that you owned on April 17, 2009. Your subscription rights will be aggregated for all of the shares that you owned on that date and then rounded down to the nearest whole number of rights, so that you will not receive any fractional rights. The subscription rights are exercisable beginning on the date of this prospectus and continuing until 5:00 p.m., Eastern Daylight Savings Time, on May 22, 2009, unless we extend the offering period. Each basic subscription right entitles you to purchase one share of common stock at a purchase price of $1.35 per share.

All of the noteholders are currently stockholders of our company. We do not have formal commitments from any of the noteholders to participate in the rights offering, and we cannot assure you that any of them will exercise all or any part of their basic subscription privilege or their over-subscription privilege.

There is no minimum number of rights that must be exercised in this rights offering, and all net proceeds will be made immediately available to us for the purposes set forth in this prospectus. We cannot assure you that any shares of common stock will be sold in this offering. In the event that we raise at least $2.5 million of gross proceeds from the sale of common stock upon exercise of rights in this offering, the principal and accrued interest outstanding under the notes will become due and payable.

The subscription rights may not be sold or transferred. The subscription rights will not be listed for trading on any stock exchange or trading market. You should carefully consider whether to exercise your subscription rights before the expiration of the rights offering. All exercises of subscription rights are irrevocable. Our Board of Directors is making no recommendation regarding your exercise of the subscription rights.

Our common stock is traded on the Nasdaq Global Market under the symbol KONA. On April 9, 2009, the last sale price of our common stock as reported on the Nasdaq Global Market was $1.98 per share. The shares of common stock issued in the rights offering will also be listed on the Nasdaq Global Market under the same symbol.

See Risk Factors, beginning on page 7, for a discussion of certain risk factors that you should consider before exercising your rights to purchase shares of our common stock.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the accuracy or adequacy of this prospectus. Any representation to the contrary is a criminal offense.

If you have any questions or need further information about this rights offering, please call Morrow & Co., LLC, our information agent for the rights offering, at (203) 658-9400 (collect) or (800) 607-0088 (toll-free).

The date of this prospectus is April 17, 2009

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SUMMARY

The following summary provides information about our company and this rights offering. This summary is not complete and does not contain all of the information that you should consider before exercising your subscription rights. You should carefully review the detailed information and financial statements, including the notes thereto, contained or incorporated by reference in this prospectus. Unless otherwise indicated, all information in this prospectus assumes no exercise of any currently outstanding stock options or warrants. References to the company or we, us, and our refers to Kona Grill, Inc.

Our Company

Overview

We own and operate 21 upscale casual dining restaurants in 13 states. Kona Grill restaurants offer freshly prepared food, personalized service, and a contemporary ambiance that create an exceptional, yet affordable dining experience that we believe exceeds many traditional casual dining restaurants with whom we compete. Our high-volume upscale casual restaurants feature a diverse selection of mainstream American dishes as well as a variety of appetizers and entrees with an international influence, including an extensive selection of award-winning sushi. Our menu items also incorporate over 40 signature sauces and dressings that we make from scratch, creating broad based appeal for the lifestyle and taste trends of a diverse group of guests. Our diverse menu offerings are complemented by a full service bar offering a broad assortment of wines, specialty drinks, and beers. Our menu is mostly standardized for all of our restaurants allowing us to deliver consistent, high quality meals.

Our restaurants accommodate a range of approximately 260 to 300 guests and are comprised of multiple dining areas that incorporate modern design elements to create an upscale ambiance that reinforces our high standards of food and service. Our main dining area, full-service bar, outdoor patio, and sushi bar provide a choice of atmospheres and a variety of environments designed to appeal and encourage repeat visits from regular guests. We locate our restaurants in high-activity areas such as retail centers, shopping malls, and lifestyle centers that are situated near commercial office space and residential housing to attract guests throughout the day. Our restaurants are designed to satisfy our guests dining preferences during lunch, dinner, and non-peak periods such as late afternoon and late night.

We believe that the portability of our concept has been successfully demonstrated in a variety of markets across the United States. Our primary growth objective is to gradually expand the Kona Grill concept in selected markets over the next several years. Accordingly, we intend to continue developing Kona Grill restaurants in high quality, densely populated areas in both new and existing markets. We plan to open four restaurants during 2009 as we continue to expand our national presence. Scheduled openings include new markets such as Richmond, Virginia which opened in January 2009; Woodbridge, New Jersey; Eden Prairie, Minnesota; and Tampa, Florida.

We believe that our vast array of menu offerings and generous portions combined with an estimated average check per guest during 2008 of approximately $24.00 offers our guests an attractive price-value proposition. This value proposition, coupled with our multiple daypart model and exceptional service, have created an attractive business model. Furthermore, our restaurant model provides us with considerable growth opportunities to expand the Kona Grill concept. We believe our concept has the potential for over 100 restaurants nationwide.

Our Competitive Strengths

We believe that the key strengths of our business include the following:

Innovative Menu Selections with Mainstream Appeal. We offer a menu of freshly prepared food that includes a diverse selection of mainstream American selections, a variety of appetizers and entrees with an international influence, and award-winning sushi to appeal to a wide range of tastes, preferences, and price points. We prepare our dishes from original recipes with generous portions and creative and appealing presentations that adhere to standards that we believe are much closer to fine dining than typical casual dining.

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Distinctive Upscale Casual Dining Experience. Our upscale casual dining concept captures some of the best elements of fine dining including a variety of exceptional food, impeccable service, and an extensive wine and drink list, and combines them with more casual qualities, like a broad menu with attractive price points and a choice of environments to fit any dining occasion, enabling us to attract a broad guest demographic. Our innovative menu, personalized service, and contemporary restaurant design blend together to create our upscale casual dining experience.

Personalized Guest Service. Our commitment to provide prompt, friendly, and efficient service enhances our food, reinforces our upscale ambiance, and helps distinguish us from other traditional casual dining restaurants.

Multiple Daypart Model. Our appetizers, pizzas, entrees, and sushi offerings provide a flexible selection of items that can be ordered individually or shared by our guests, allowing them to dine with us during traditional lunch and dinner meal periods as well as in between customary dining periods such as in the late afternoon and late night.

Attractive Unit Economics. During 2008, the average unit volume of our restaurants open for at least 12 months was $4.3 million, or $608 per square foot. We believe our high average unit volume helps us attract high-quality employees, leverage our fixed costs, and makes us a desirable tenant for landlords. We expect the average cash investment for our new restaurants to be approximately $2.5 million, net of landlord tenant improvement allowances and excluding preopening expenses. Restaurants that are subject to ground leases and do not receive landlord tenant improvement allowances may require a significantly higher cash investment, but typically have lower average rental costs over the duration of the lease. Our restaurant cash flow margin is one of the best in our industry and provides us with strong financial returns on this investment.

Our Growth Strategy

We believe that there are significant opportunities to grow our sales, expand our concept, and increase our brand awareness throughout the United States. The following sets forth the key elements of our growth strategy.

Pursue disciplined restaurant growth. We adhere to a disciplined site selection process and intend to continue opening Kona Grill restaurants in both new and existing markets that meet our demographic, real estate, and investment criteria. In 2009, we plan to open all of our restaurants in new markets to continue to build awareness of our concept and to establish Kona Grill as a national upscale casual brand. In 2010 and beyond, we expect the rate of new unit expansion to slow if the cost of capital remains high and the availability of quality new restaurant sites is minimal. Our expansion plans do not involve any franchised restaurant operations.

Grow existing restaurant sales. Our goal for existing restaurants is to improve unit volumes through ongoing local marketing efforts designed to generate awareness and trial of our concept and increase the frequency of guest visits.

Leverage depth of existing corporate infrastructure. We believe that successful execution of our growth strategies will enable Kona Grill to be a leading upscale casual dining restaurant operator in the United States. During 2008, we continued to make strategic investments in our corporate infrastructure by implementing information systems and establishing financial controls to minimize risks associated with our current growth strategy. As we continue to realize the benefits of our growth, we believe that we will be able to leverage our investments in corporate infrastructure and realize benefits from the increasing sales volume that our company generates.

Our Offices

Our executive offices are located at 7150 East Camelback Road, Suite 220, Scottsdale, Arizona 85251, and our telephone number is (480) 922-8100. Our website is located at *www.konagrill.com*. The information contained on our website or that can be accessed through our website does not constitute part of this prospectus.

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QUESTIONS AND ANSWERS ABOUT THE RIGHTS OFFERING

The following are examples of what we anticipate may be common questions about the rights offering. The answers are based on selected information from this prospectus. The following questions and answers do not contain all of the information that may be important to you and may not address all of the questions that you may have about the rights offering. This prospectus and the documents incorporated by reference herein contain more detailed descriptions of the terms and conditions of the rights offering and provide additional information about us and our business, including potential risks related to the rights offering, our common stock and our business.

What is a Rights Offering?

A rights offering is an opportunity for our stockholders to purchase additional shares of common stock at a fixed price to be determined before the rights offering begins and in an amount proportional to the stockholders existing interests. This rights offering enables our company to raise additional capital while enabling our existing stockholders to maintain their current percentage ownership in our company.

What is a Subscription Right?

We are distributing to you, at no charge, one subscription right for every 2.5 shares of common stock that you owned on April 17, 2009. Your subscription rights will be aggregated for all of the shares that you owned on that date and then rounded down to the nearest whole number of rights, so that you will not receive any fractional rights. Each subscription right entitles you to purchase one share of common stock for $1.35. When you exercise a subscription right, you choose to purchase the common stock that the subscription right entitles you to purchase. You may exercise any or all of your subscription rights, or you may choose not to exercise any subscription rights. You cannot transfer or sell your subscription rights to anyone else; only you can exercise them.

Why are We Engaging in a Rights Offering?

During March, 2009, we sold $1.2 million aggregate principal amount of 10% unsecured subordinated notes and warrants to purchase shares of our common stock to four holders of our common stock. As part of this transaction, we agreed to file with the SEC a registration statement to conduct a rights offering with targeted gross proceeds to us of at least $2.5 million. Further, the terms of this transaction provided that any shares of our common stock available for subscription in the rights offering that are not subscribed by existing stockholders shall be offered to the noteholders on a pro rata basis based on the aggregate principal amount of notes outstanding and at the same subscription price as offered to the existing stockholders pursuant to the basic subscription privilege.

We are offering the subscription rights to our current stockholders in order to raise up to approximately $3.52 million in additional capital. We intend to use these additional funds to supplement our operating cash flows and fund capital expenditure requirements. Our Board of Directors has chosen to give you the opportunity to purchase additional shares to maintain your current percentage ownership in our company and provide us with additional capital. We cannot assure you that we will not need to seek additional financing in the future.

What is the Basic Subscription Privilege?

The basic subscription privilege of each subscription right entitles you to purchase one share of our common stock at a subscription price of $1.35. You may exercise your basic subscription privilege for some or all of your rights.

What is the Over-Subscription Privilege?

We do not expect that all of our stockholders will choose to exercise all of their basic subscription rights. By extending over-subscription privileges solely to the noteholders, we are providing the noteholders with the opportunity to purchase those shares that are not purchased by other stockholders through the exercise of their basic subscription privileges. The over-subscription privilege entitles the noteholders to subscribe for those shares of common stock not acquired by other holders of rights, on a pro rata basis based on the aggregate principal amount of notes outstanding, at the same subscription price of $1.35 per share. We do not have formal commitments from

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any of the noteholders to participate in the rights offering, and we cannot assure you that any of them will exercise all or any part of their basic subscription privilege or their over-subscription privilege.

What are the Limitations on the Over-Subscription Privilege?

We will issue a maximum of 2,608,125 shares of common stock in this rights offering, including both basic subscription and over-subscription rights. The number of shares available for over-subscription privileges to the noteholders will be 2,608,125 minus the number of shares purchased upon exercise of all basic subscription privileges. If sufficient shares are available after any basic subscription rights are exercised, we will seek to honor the noteholders over-subscription requests in full. If over-subscription requests from the noteholders exceed the number of shares available in this offering, we will allocate the available shares among noteholders on a pro rata basis based on the aggregate principal amount of notes outstanding. However, if such noteholder s pro rata allocation exceeds the number of shares requested, the noteholder will receive only the number of shares requested, and the remaining shares from the pro rata allocation will be divided among the other noteholders on a pro rata basis based on the aggregate principal amount of notes outstanding. See The Rights Offering Over-Subscription Privilege for a more detailed explanation of how we will allocate over-subscribed shares. In certain circumstances, however, in order to comply with applicable state securities laws, we may not be able to honor all over-subscription privileges, even if we have shares available.

How Many Shares May I Purchase?

You will receive one subscription right for every 2.5 shares of common stock that you owned on April 17, 2009. Your subscription rights will be aggregated for all of the shares that you owned on that date and then rounded down to the nearest whole number of rights, so that you will not receive any fractional rights. Each subscription right entitles you to purchase one share of common stock for $1.35. Only the noteholders may have the opportunity to purchase additional shares of common stock for $1.35 per share beyond their opportunity to purchase shares pursuant to their basic subscription right. Subject to state securities laws and regulations, we have the discretion to issue fewer than the total number of shares that may be available for over-subscription requests in order to comply with state securities laws.

How Did We Arrive at the Offering Price Per Share?

A special committee of our Board of Directors, consisting of three independent directors, in consultation with KeyBanc Capital Markets Inc., financial advisor to the special committee, considered several factors in determining the price at which a share of common stock may be purchased in this rights offering. These factors included the historic and then current market price of the common stock, our business prospects, our recent and anticipated operating results, general conditions in the securities markets, our need for capital, alternatives available to us for raising capital, the amount of proceeds desired, the pricing of similar transactions, the liquidity of our common stock, the level of risk to our investors, and the need to offer shares at a price that would be attractive to our investors relative to the current trading price of our common stock.

How Do I Exercise My Subscription Rights?

You must properly complete the attached subscription certificate and deliver it to the Subscription Agent before 5 p.m., Eastern Daylight Savings Time, on May 22, 2009. The address for the Subscription Agent is on page 30 of this prospectus. Your subscription certificate must be accompanied by proper payment for each share that you wish to purchase.

Must I Pay the Subscription Price in Cash?

Yes. You must timely pay the full subscription price for the basic subscription privileges and the over-subscription privilege you wish to exercise by certified or cashier s check drawn on a U.S. bank, U.S. postal money order, or personal check that clears before the expiration date of the rights offering.

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What if a Bank, Broker, or Other Nominee is the Record Holder of my Shares?

If you wish to exercise your rights, please promptly contact the bank, broker, or other nominee holding your shares. Your bank, broker, or other nominee holder is the holder of the shares you own and must exercise the rights on your behalf for shares you wish to purchase. The bank, broker, or other nominee has been requested to contact you for instructions on exercising your rights.

How Long Will the Rights Offering Last?

You will be able to exercise your subscription rights only during a limited period. If you do not exercise your subscription rights before 5 p.m., Eastern Daylight Savings Time, on May 22, 2009, your subscription rights will expire. We may, in our discretion, extend the rights offering for up to 15 days. In addition, if the commencement of the rights offering is delayed, the expiration date will similarly be extended.

After I Exercise My Subscription Rights, Can I Change My Mind?

No. Once you send in your subscription certificate and payment, you cannot revoke the exercise of your subscription rights, even if you later learn information about us that you consider to be unfavorable. You should not exercise your subscription rights unless you are certain that you wish to purchase additional shares of our common stock at a price of $1.35 per share.

Is Exercising My Subscription Rights Risky?

The exercise of your subscription rights involves certain risks. Exercising your subscription rights means purchasing additional shares of our common stock, and you should carefully consider this investment as you would view other equity investments. Among other things, you should carefully consider the risks described under the heading Risk Factors in this prospectus.

Has the Board of Directors Made a Recommendation Regarding the Rights Offering?

The decision whether to exercise your rights must be made by you based on your evaluation of our business and the terms of the offering. Our Board of Directors does not make any recommendation to you about whether you should exercise your rights.

What Fees or Charges Apply if I Exercise My Rights?

We are not charging any fees or sales commissions to issue rights to you or to issue shares to you if you exercise your rights. If you exercise your rights through a broker or other holder of your shares, you are responsible for paying any fees that person may charge.

When Will I Receive My New Shares of Common Stock?

If you purchase shares of common stock through the rights offering, we will issue certificates representing those shares to you or The Depository Trust Company, or DTC, on your behalf, as the case may be, as soon as practicable after the completion of the rights offering. Subject to state securities laws and regulations, we have the discretion to delay distribution of any shares you may have elected to purchase by exercise of your rights in order to comply with state securities laws.

Will the Rights be Listed on a Stock Exchange or National Market?

No. The rights will not be listed on the Nasdaq Global Market or any other stock exchange or national market. Our common stock trades on the Nasdaq Global Market under the symbol KONA, and the shares to be issued in connection with the rights offering will be eligible for trading on the Nasdaq Global Market.

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What Happens If I Choose Not to Exercise My Subscription Rights?

You will retain your current number of shares of common stock in our company even if you do not exercise your subscription rights. However, if other stockholders exercise their subscription rights and you do not exercise your basic subscription privilege in full, your percentage ownership interest in our company will diminish, and your relative voting rights and economic interests will be diluted.

Can I Sell or Give Away My Subscription Rights?

No. You may not transfer or sell your subscription rights to anyone else; only you can exercise them.

Must I Exercise Any Subscription Rights?

No. Exercise of your subscription rights is optional.

What Are the Federal Income Tax Consequences of Exercising My Subscription Rights?

The receipt and exercise of your subscription rights are intended to be nontaxable. You should seek specific tax advice from your personal tax advisor. See the further discussion under Federal Income Tax Considerations in this prospectus.

Can We Cancel the Rights Offering?

Yes. Our Board of Directors may cancel the rights offering at any time on or before May 22, 2009, for any reason. If we cancel this rights offering, we will promptly refund any money that we received from stockholders, without interest.

How Much Money Will Kona Grill, Inc. Receive From the Rights Offering?

Our gross proceeds from the rights offering will depend on the number of shares that are purchased. If we sell all 2,608,125 shares that may be purchased upon exercise of the rights or other sales of unsubscribed shares offered by this prospectus, then we will receive proceeds of approximately $3.52 million, before deducting expenses payable by us. We estimate that those expenses will be approximately $275,000. Certain of our directors and executive officers may subscribe in this rights offering; however, we do not currently know the number of shares such directors and executive officers will obtain upon exercise of the rights, and thus are unable to determine the gross proceeds we will receive from subscriptions by our directors and executive officers.

How Will We Use the Proceeds From the Rights Offering?

We will use the proceeds from the rights offering to supplement our operating cash flows and fund capital expenditure requirements. In the event we raise at least $2.5 million in this rights offering, the promissory notes held by the noteholders will be redeemed using proceeds from this rights offering.

How Many Shares Will Be Outstanding After the Rights Offering?

There were 6,520,313 shares of common stock outstanding as of April 9, 2009. The number of shares of common stock that will be outstanding after this rights offering will depend on the number of shares that are purchased. If we sell all of the shares offered by this prospectus, then we will issue a maximum of 2,608,125 new shares of common stock during this rights offering. In that case, we will have up to 9,128,438 shares of common stock outstanding after this rights offering. The number of shares of common stock we will issue in this rights offering may be lower due to rounding down of fractional shares.

What If I Have More Questions?

If you have any questions or need further information about this rights offering, please call Morrow & Co., LLC, our information agent for the rights offering, at (203) 658-9400 (collect) or (800) 607-0088 (toll-free).

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RISK FACTORS

You should carefully consider the following factors and other information contained or incorporated by reference in this prospectus before deciding to purchase shares of our common stock in the rights offering. The risks described below are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial may also materially and adversely affect our business operations. If any of the following risks actually occurs, our business, results of operations and financial condition could suffer. In that case, the trading price of our common stock could decline, and you may lose all or part of your investment.

Risks Related to Our Company

We have a limited operating history and a limited number of restaurants upon which to evaluate our company, and you should not rely on our history as an indication of our future results.

We currently operate 21 restaurants, half of which have operated for less than three years. Consequently, the results we have achieved to date with a relatively small number of restaurants may not be indicative of those restaurants long-term performance or the potential performance of new restaurants. A number of factors historically have affected and are likely to continue to affect our average unit volumes and comparable restaurant sales, including the following:

- our ability to execute effectively our business strategy;
- our ability to successfully select and secure sites for our Kona Grill concept;
- the operating performance of new and existing restaurants;
- competition in our markets;
- consumer trends; and
- changes in political or economic conditions.

Our average unit volume and same-store sales may not increase at rates achieved over recent periods, or may decrease. Two of our restaurants opened within the last three years have average unit volumes significantly below the average unit volume of our comparable restaurant base. In addition, we closed our restaurant in Naples, Florida in September 2008 due to low sales volume. Changes in our average unit volumes and comparable restaurant sales could cause the price of our common stock to fluctuate substantially.

We have a history of losses and we may never achieve profitability.

We incurred net losses during each of the last four years. We forecast that we will incur net losses for at least the next year, and possibly longer. We expect that our expenses for the foreseeable future will increase in order to continue the development of new restaurants. We may find that these efforts are more expensive than we currently anticipate or that our expansion efforts do not result in proportionate increases in our sales, which would further increase our losses. We cannot predict whether we will be able to achieve profitability in the future.

We depend on the proceeds of this offering to satisfy certain of our current lease and construction obligations for planned new restaurant openings.

Our capital requirements, including development costs related to the opening of new restaurants, have historically been significant. Our future cash requirements and the adequacy of available funds depends on many factors, including the operating performance of our restaurants, the pace of expansion, real estate markets, site locations, the nature of the arrangements negotiated with landlords, and the credit market environment. Based upon anticipated cash flow generated from operations and availability under our line of credit, we have insufficient cash to fund planned restaurant openings in 2009. We have suspended construction of one restaurant and delayed the start of construction on another restaurant planned to open in 2009 pending the closing of this offering. To meet anticipated capital expenditures during the next twelve months, we plan to secure funding through sources that may include private or public equity or debt financing, including funding from this offering. We can provide no assurance that we will be successful in raising necessary funds. If we are unable to secure such funding, we may be required to terminate existing leases, or continue to delay, scale back, or cease construction of our planned new restaurant facilities, which could subject us to penalties and materially and adversely impact our ability to grow our business.

We may require additional capital in the future as a result of changes in our restaurant operations or growth plans, and our inability to raise such capital could harm our operations and restrict our growth.

Changes in our restaurant operations, acceleration of our restaurant expansion plans, lower than anticipated restaurant sales, increased food or labor costs, increased property expenses, or other events, including those described in this prospectus, may cause us to seek additional debt or equity financing on an accelerated basis. Financing may not be available to us on acceptable terms, or at all, and our failure to raise capital when needed could negatively impact our restaurant growth plans as well as our financial condition and results of operations. Additional equity financing, if available, will be dilutive to the holders of our common stock. Debt financing may involve significant cash payment obligations, covenants, and financial ratios that may restrict our ability to operate and grow our business, and would cause us to incur additional interest expense and financing costs.

Recent disruptions in the capital and credit markets may adversely affect our business, including the availability and cost of funding, which could adversely affect our results of operations, cash flows, and financial condition.

Our growth strategy depends upon our ability to access the capital markets to obtain funds to expand our operations. Recent disruptions in the capital and credit markets have adversely affected our ability to borrow money from banks or other potential lenders. Our access to funds under any potential credit facility will depend on the ability of the banks or other lenders to commit to lend funds to us. In the event we enter into a credit facility with banks or other lenders, those parties may not be able to meet their funding commitments to us if they experience shortages of capital or if they experience excessive volumes of borrowing requests from us and other borrowers within a short period of time.

Longer term disruptions in the capital and credit markets as a result of uncertainty, changing or increased regulation, or failures of significant financial institutions could adversely affect our access to capital. Any long-term disruption could require us to take measures to conserve cash until the markets stabilize or until alternative credit arrangements or other funding for our business can be arranged. Such measures could result in deferring capital expenditures or altering our growth strategy to reduce the opening of new restaurants.

Our future operating results and financial position may fluctuate significantly due to our limited number of existing restaurants and the expenses and capital expenditures required to open new restaurants.

We currently operate 21 restaurants, three of which opened during 2008, and we expect to open four restaurants during 2009. The capital resources required to develop each new restaurant are significant. We estimate that the cost of opening a new Kona Grill restaurant currently ranges from $3.2 million to $4.5 million, exclusive of landlord tenant improvement allowances and preopening expenses and assuming that we do not purchase the underlying real estate. Actual costs may vary significantly depending upon a variety of factors, including the site and size of the restaurant and conditions in local real estate and employment markets. The combination of our relatively small number of existing restaurants, the significant investment associated with each new restaurant, and the average unit volumes of our new restaurants may cause our results of operations and financial position to fluctuate significantly, and poor operating results at any one restaurant or a delay or cancellation in the planned opening of a restaurant could materially affect our company, making the investment risks related to any one location much larger than the risks associated with any given restaurant location within other restaurant chains.

Unexpected expenses and low market acceptance of our restaurant concept could adversely affect the profitability of restaurants that we open in new markets.

As part of our expansion strategy, we plan to open restaurants in markets in which we have no prior operating experience and in which our brand may not be well-known. These new markets may have different competitive conditions, consumer tastes, and discretionary spending patterns than restaurants in our existing markets. As a

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result, we may incur costs related to the opening, operation, and promotion of these new restaurants that are greater than those incurred in existing markets. As a result of these factors, sales at restaurants opening in new markets may take longer to achieve average unit volumes comparable with our existing restaurants, if at all, which would adversely affect the profitability of those new restaurants.

Our ability to open new restaurants on schedule in accordance with our projected growth rate may be adversely affected by delays or problems associated with securing suitable restaurant locations and leases and by other factors, some of which are beyond our control and the timing of which is difficult to forecast accurately.

Due in part to the unique nature of each proposed restaurant location, we cannot predict the timing or ultimate success of our site selection process. Our ability to open new restaurants on schedule depends upon a number of factors, many of which are beyond our control, including the following:

- the availability and cost of suitable restaurant locations for development and our ability to compete successfully for those locations;
- the availability of adequate financing;
- the timing of delivery of leased premises from our landlords so we can commence our build-out construction activities;
- construction and development costs;
- labor shortages or disputes experienced by our landlords or outside contractors;
- unforeseen engineering or environmental problems with the leased premises;
- our ability to secure governmental approvals and permits, including liquor licenses, construction permits, and occupancy permits;
- weather conditions or natural disasters; and
- general economic conditions.

Our growth may strain our infrastructure and resources, which could slow our development of new restaurants and adversely affect our ability to manage our existing restaurants.

We plan to open four restaurants in 2009 which would result in 20% unit growth. This expansion and our future growth will increase demands on our management team, restaurant management systems and resources, financial controls, and information systems. These increased demands may adversely affect our ability to manage our existing restaurants. If we fail to continue to improve our infrastructure or to manage other factors necessary for us to meet our expansion objectives, our operating results could be adversely affected.

Our restaurants are subject to natural disasters and other events which are beyond our control and for which we may not be able to obtain insurance at reasonable rates.

We endeavor to insure our restaurants against wind, flood, and other disasters, but we may not be able to obtain insurance for these types of events for all of our restaurants at reasonable rates. A devastating natural disaster or other event in the vicinity of one of our restaurants could result in substantial losses and have a material adverse affect on our results of operations.

Our expansion in existing markets may cause sales in some of our existing restaurants to decline.

Our growth strategy includes opening new restaurants in our existing markets. We may be unable to attract enough guests to our new restaurants for them to operate profitably. In addition, guests to our new restaurants may be former guests of one of our existing restaurants in that market, which may reduce guest visits and sales at those existing restaurants, adversely affecting our results of operations.

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If our distributors or suppliers do not provide food and beverages to us in a timely fashion, we may experience short-term supply shortages and increased food and beverage costs.

We currently depend on U.S. Foodservice, a national food distribution service company, and other regional distributors to provide food and beverage products to all of our restaurants. If U.S. Foodservice or other distributors or suppliers cease doing business with us, we could experience short-term supply shortages in some or all of our restaurants and could be required to purchase food and beverage products at higher prices until we are able to secure an alternative supply source. In addition, any delay in replacing our suppliers or distributors on acceptable terms could, in extreme cases, require us to remove temporarily items from the menus of one or more of our restaurants, which also could adversely affect our business.

Our failure to protect our trademarks, service marks, or trade secrets could negatively affect our competitive position and the value of the Kona Grill brand.

Our business prospects depend in part on our ability to develop favorable consumer recognition of the Kona Grill name. Although Kona Grill is a federally registered trademark, our trademarks and service marks could be imitated in ways that we cannot prevent. Alternatively, third parties may attempt to cause us to change our name or not operate in a certain geographic region if our name is confusingly similar to their name. In addition, we rely on trade secrets, proprietary know-how, concepts, and recipes. Our methods of protecting this information may not be adequate. Moreover, we may face claims of misappropriation or infringement of third parties rights that could interfere with our use of this information. Defending these claims may be costly and, if unsuccessful, may prevent us from continuing to use this proprietary information in the future, and may result in a judgment or monetary damages. We do not maintain confidentiality and non-competition agreements with all of our executives, key personnel, or suppliers. If competitors independently develop or otherwise obtain access to our trade secrets, proprietary know-how, or recipes, the appeal of our restaurants could be reduced and our business could be harmed.

We are dependent upon high levels of consumer traffic at the sites where our restaurants are located and any adverse change in consumer activity could negatively affect our restaurant sales and may require us to record an impairment charge for restaurants performing below expectations.

Our restaurants are primarily located in high-activity areas such as retail centers, shopping malls, and lifestyle centers. We depend on high consumer traffic rates at these centers to attract guests to our restaurants. In general, such visit frequencies are significantly affected by many factors, including national, regional, or local economic conditions, anchor tenants closing in retail centers or shopping malls in which we operate, changes in consumer preferences or shopping patterns, higher frequency of online shopping, changes in discretionary consumer spending, increasing gasoline prices, or otherwise, our unit volumes could decline and adversely affect our results of operations, including recording an impairment charge for restaurants that are performing below expectations. During 2008, we recorded impairment charges for our Naples, Florida restaurant that was closed during September 2008 and for our low sales volume restaurant in Lincolnshire, Illinois.

We may be required to record impairment charges in future quarters as a result of the decline in value of our investments in auction rate securities.

We hold investments in auction rate securities which are secured by student loans. While the maturity dates of our auction rate securities range from 2029 to 2046, liquidity for these securities has historically been provided by an auction process that resets the applicable interest rate at pre-determined calendar intervals, generally every 28 days. The recent uncertainties in the credit markets have adversely affected the auction market for these types of securities and auctions for these securities have failed to settle on their respective settlement dates. Consequently, our investments in auction rate securities are not currently liquid and we will not be able to redeem these securities until a future auction of these investments is successful, the issuer refinances the underlying debt, or our investment provider purchases the securities pursuant to the settlement agreement discussed in Note 3 to the consolidated financial statements in our Form 10-K for the fiscal year ended December 31, 2008.

Estimating the fair value of auction rate securities requires numerous assumptions such as assessments of the underlying structure of each security, expected cash flows, credit ratings, and other relevant factors. These assumptions, assessments and the interpretations of relevant market data are subject to uncertainties, are difficult to predict and require significant judgment. The use of different assumptions, applying different judgment to inherently subjective matters and changes in future market conditions could result in significantly different estimates of fair value. There is no assurance as to when the market for auction rate securities will stabilize. The fair value of our auction rate securities could change significantly based upon market conditions and continued uncertainties in the credit markets. If these uncertainties continue or if our securities experience credit rating downgrades or changes in the rates of default on the underlying assets, we may incur additional impairment on our auction rate securities portfolio.

Risks Related to the Restaurant Industry

Negative publicity surrounding our restaurants or the consumption of beef, seafood, poultry, or produce generally, or shifts in consumer tastes, could negatively impact the popularity of our restaurants, our sales, and our results of operations.

The popularity of our restaurants in general, and our menu offerings in particular, are key factors to the success of our operations. Negative publicity resulting from poor food quality, illness, injury, or other health concerns, whether related to one of our restaurants or to the beef, seafood, poultry, or produce industries in general (such as negative publicity concerning salmonella, e-coli, Hepatitis A, mercury poisoning and other food-borne illnesses), or operating problems related to one or more of our restaurants, could make our brand and menu offerings less appealing to consumers. In addition, other shifts in consumer preferences away from the kinds of food we offer, whether because of dietary or other health concerns or otherwise, would make our restaurants less appealing and adversely affect our sales and results of operations. If our restaurants are unable to compete successfully with other restaurants in new and existing markets, our results of operations will be harmed and we will not achieve profitability.

Increases in the prices of, or reductions in the availability of, seafood, poultry, beef, or produce could reduce our operating margins and adversely affect our operating results.

Our profitability depends, in part, on our ability to anticipate and react to changes in seafood, poultry, beef, or produce costs. The supply and price of these items is more volatile than other types of food. The type, variety, quality, and price of seafood, poultry, beef, and produce is subject to factors beyond our control, including adverse weather conditions, transportation costs, governmental regulation, availability, and seasonality, each of which may affect our food costs or cause a disruption in our supply. We currently do not purchase seafood, poultry, beef, or produce pursuant to long-term contracts or use financial management strategies to reduce our exposure to price fluctuations. Changes in the price or availability of certain types of seafood, poultry, beef, or produce could affect our ability to offer a broad menu and price offering to our guests and could reduce our operating margins and adversely affect our results of operations.

Regulations affecting the operation of our restaurants could increase operating costs, restrict our growth, or require us to suspend operations.

Each of our restaurants must obtain licenses from regulatory authorities allowing it to sell liquor, beer, and wine, and each restaurant must obtain a food service license from local health authorities. Each restaurant s liquor license must be renewed annually and may be revoked or suspended at any time for cause, including violation by us or our employees of any laws and regulations relating to the minimum drinking age, over serving, advertising, wholesale purchasing, and inventory control. Each restaurant is also subject to local health inspections. Failure to pass one or multiple inspections may result in temporary or permanent suspension of operations and could significantly impact our reputation. In certain states, including states where we have existing restaurants or where we plan to open restaurants in the near term, the number of liquor licenses available is limited and licenses are traded at market prices.

Liquor, beer, and wine sales comprise a significant portion of our sales, representing approximately 32% of our sales during 2008. Therefore, if we are unable to maintain our existing licenses, or if we choose to open a restaurant in those states, the cost of a new license could be significant. Obtaining and maintaining licenses is an important component of each of our restaurant s operations, and the failure to obtain or maintain food and liquor licenses and other required licenses, permits, and approvals would adversely impact our restaurants and our growth strategy.

In addition, the Federal Americans with Disabilities Act prohibits discrimination on the basis of disability in public accommodations and employment. Although our restaurants are designed to be accessible to the disabled, we could be required to reconfigure our restaurants to provide service to, or make reasonable accommodations for, disabled persons. Non-compliance with this law and related laws enacted at the state or local level could result in the imposition of fines or an award of damages in litigation.

Litigation concerning our food quality, our employment practices, liquor liability, and other issues could result in significant expenses to us and could divert resources from our operations.

Like other restaurants, we may receive complaints or litigation from, and potential liability to, our guests involving food-borne illness or injury or other operational issues. We may also be subject to complaints or allegations from, and potential liability to, our former, existing, or prospective employees involving our restaurant employment practices and procedures. In addition, we are subject to state dram shop laws and regulations, which generally provide that a person injured by an intoxicated person may seek to recover damages from an establishment that wrongfully served alcoholic beverages to such person. Recent litigation against restaurant chains has resulted in significant judgments, including punitive damages, under dram shop statutes. While we carry liquor liability coverage as part of our existing comprehensive general liability insurance, we may still be subject to a judgment in excess of our insurance coverage and we may not be able to obtain or continue to maintain such insurance coverage at reasonable costs, if at all. Regardless of whether any claims against us are valid or whether we are liable, our sales may be adversely affected by publicity resulting from such claims. Such claims may also be expensive to defend and may divert time and money away from our operations and adversely affect our business.

Labor shortages or increases in labor costs could slow our growth or adversely affect our business.

Our success depends in part on our ability to attract, motivate, and retain a sufficient number of qualified employees, including restaurant general managers and kitchen managers, necessary to continue our operations and keep pace with our growth. This ability is especially critical to our company because of our relatively small number of existing restaurants and our current development plans. If we are unable to recruit and retain a sufficient number of qualified employees, our business and growth strategy could be adversely affected.

Competition for qualified restaurant employees in our current or prospective markets could require us to pay higher wages and benefits, which could result in higher labor costs. In addition, we have a substantial number of hourly employees who are paid rates based upon the federal or state minimum wage and who rely on tips for a significant portion of their income. Government-mandated increases in minimum wages, overtime pay, health benefits, or increased tax reporting and tax payment requirements for employees who receive gratuities, or a reduction in the number of states that allow tips to be credited toward minimum wage requirements, could increase our labor costs. We may be unable to increase our prices proportionately in order to pass these increased costs on to our guests, in which case our operating margins would be adversely affected.

Risks Related to Ownership of Our Common Stock

The market price for our common stock may be volatile.

Many factors could cause the market price of our common stock to rise and fall, including but not limited to the following:

actual or anticipated variations in comparable restaurant sales or operating results; whether in our operations or those of our competitors;

changes in the consumer spending environment or general economic conditions;

changes in the market valuations of other companies in the restaurant industry;

recruitment or departure of key restaurant operations or management personnel;

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changes in the estimates of our operating performance or changes in recommendations by any research analysts that follow our stock; and

announcements of investigations or regulatory scrutiny of our restaurant operations or lawsuits filed against us.

Due to the volatility of our stock price, we also may become the target of securities litigation. Securities litigation could result in substantial costs and divert our management s attention and resources from our business as well as depress the price of our common stock.

Our current principal stockholders own a large percentage of our voting stock, which allows them to control substantially all matters requiring stockholder approval.

Investors affiliated with our Chairman, President, and Chief Executive Officer, Marcus Jundt, together potentially own approximately 26% of our common stock on a fully diluted basis. In addition, three of our directors (including Mr. Jundt) are affiliated with Mr. Jundt. As a result, Mr. Jundt has significant influence over our decision to enter into any corporate transaction and may have the ability to prevent any transaction that requires the approval of stockholders, regardless of whether or not our other stockholders believe that such transaction is in their own best interests. Such concentration of voting power could have the effect of delaying, deterring, or preventing a change of control or other business combination, which could in turn have an adverse effect on the market price of our common stock or prevent our stockholders from realizing a premium over the then-prevailing market price for their shares of common stock.

The large number of shares eligible for public sale and registered for resale could depress the market price of our common stock.

The market price for our common stock could decline as a result of sales of a large number of shares of our common stock in the market, and the perception that these sales could occur may depress the market price. As of April 9, 2009, we had outstanding 6,520,313 shares of common stock, all of which shares are either freely tradable or otherwise eligible for sale under Rule 144 under the Securities Act of 1933. In addition, we have 1,500,000 shares reserved for future issuance under our stock option and employee stock purchase plans, of which approximately 280,000 shares have been issued. We have filed registration statements under the securities laws to register the common stock to be issued under these plans. As a result, shares issued under these plans will be freely tradable without restriction unless acquired by affiliates of our company, who will be subject to the volume and other limitations of Rule 144.

We have also filed a registration statement covering the resale of 950,000 shares held by investors in our private placement transaction during November 2007 and one other stockholder. We have agreed to keep this registration effective for a period of time following the private transaction. As a result, the existence of the registration statement may have a depressive effect on the market price of our common stock.

Our stockholders rights plan may adversely affect existing stockholders.

On May 27, 2008, we adopted a stockholder rights plan that may have the effect of deterring, delaying, or preventing a change in control that might otherwise be in the best interests of our stockholders. Under the rights plan, we issued a dividend of one preferred share purchase right for each share of our common stock held by stockholders of record on May 28, 2008. Each right entitles stockholders to purchase one one-thousandth of a share of our newly created Series A Junior Participating Preferred Stock at a price of $55 per one one-thousandth of a share. The rights expire on the earlier of May 28, 2011 or May 31, 2009 if our stockholders do not approve the adoption of the corresponding rights agreement by that date, unless the rights are earlier redeemed or exchanged by us.

In general, subject to certain limited exceptions, the stock purchase rights become exercisable when a person or group acquires 20% or more of our common stock or a tender offer or exchange offer for 20% or more of our common stock is announced or commenced. After any such event, each right will entitle its holder to purchase, at the right s then-current exercise price, a number of shares of our common stock having a market value of twice the

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exercise price. The rights will cause substantial dilution to a person or group that attempts to acquire us on terms not approved by our Board of Directors.

Provisions in our certificate of incorporation, our bylaws, and Delaware law could make it more difficult for a third party to acquire us, discourage a takeover, and adversely affect existing stockholders.

Our certificate of incorporation, our bylaws, and the Delaware General Corporation Law contain provisions that may have the effect of making more difficult, delaying, or deterring attempts by others to obtain control of our company, even when these attempts may be in the best interests of stockholders. These include provisions on our maintaining a classified Board of Directors and limiting the stockholders powers to remove directors or take action by written consent instead of at a stockholders meeting. Our certificate of incorporation also authorizes our Board of Directors, without stockholder approval, to issue one or more series of preferred stock, which could have voting and conversion rights that adversely affect or dilute the voting power of the holders of common stock. Delaware law also imposes conditions on the voting of control shares and on certain business combination transactions with interested stockholders.

These provisions and others that could be adopted in the future could deter unsolicited takeovers or delay or prevent changes in our control or management, including transactions in which stockholders might otherwise receive a premium for their shares over then current market prices. These provisions may also limit the ability of stockholders to approve transactions that they may deem to be in their best interests.

Failure to maintain effective internal controls in accordance with Section 404 of the Sarbanes-Oxley Act could have a material adverse effect on our ability to produce accurate financial statements and on our stock price.

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, we have furnished a report by our management on internal control over financial reporting for the year ended December 31, 2008. To achieve compliance with Section 404, we engaged in a process to document and evaluate our internal control over financial reporting that was both challenging and time-consuming.

Subject to proposed changes by the SEC, our independent auditors will be required to issue a report on the effectiveness of our internal control over financial reporting for the year ended December 31, 2009. Despite our efforts, we can provide no assurance as to our, or our independent auditors , conclusions with respect to the effectiveness of our internal control over financial reporting under Section 404 in the future. There is a risk that neither we nor our independent auditors will be able to conclude within the prescribed timeframe that our internal controls over financial reporting are effective as required by Section 404. This could result in an adverse reaction in the financial markets due to a loss of confidence in the reliability of our financial statements.

Since we do not expect to pay any dividends for the foreseeable future, holders of our common stock may be forced to sell their stock in order to obtain a return on their investment.

We do not anticipate that we will pay any dividends to holders of our common stock in the foreseeable future. Instead, we plan to reinvest any earnings to finance our restaurant operations and growth plans. Accordingly, stockholders must rely on sales of their common stock after price appreciation, which may never occur, as the only way to realize any return on their investment. As a result, investors seeking cash dividends should not purchase our common stock.

Risks Related to this Rights Offering

If you do not exercise all of your subscription rights, you may suffer significant dilution of your percentage ownership of our common stock.

This rights offering is designed to allow all current stockholders to purchase additional shares of common stock at a fixed price to be determined before the rights offering begins and in an amount proportional to the stockholders existing interests. The purpose of this structure is to enable us to raise capital while allowing current stockholders to maintain their relative proportionate voting and economic interest. Certain of our directors and executive officers may exercise their subscription rights, in full or in part, in this offering. To the extent that current stockholders do not exercise their subscription rights and shares are purchased by other stockholders who do exercise their subscription privileges in this rights offering, the proportionate voting interest of the non-exercising stockholders will be reduced significantly, and the percentage of our expanded equity that their original shares represent after exercise of the subscription rights and any over-subscription rights will be disproportionately diluted.

The price of our common stock may decline before or after the subscription rights expire.

The market price of our common stock could be subject to significant fluctuations in response to general market conditions, our operating results, changes in earnings estimates by securities analysts or our ability to meet those estimates, publicity regarding our industry in general, and other factors. Our revenue and operating results may vary significantly as a result of a number of factors, many of which are not in our control.