

KONA GRILL INC
Form 10-K
March 22, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

(Mark one)

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

For the fiscal year ended December 31, 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

(State or other jurisdiction of incorporation or organization)

20-0216690

(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)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class

Name of Each Exchange on Which Registered

Common Stock, par value \$0.01 per share NASDAQ Global Market

Preferred Stock Purchase Rights NASDAQ Global Market

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer 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

The aggregate market value of common stock held by non-affiliates of the registrant as of the last business day of the registrant's most recently completed second fiscal quarter, June 30, 2017, was approximately \$27,000,000, calculated based on the closing price of the registrant's common stock as reported by the NASDAQ Global Market. For purposes of this computation, all officers, directors, and 10% beneficial owners of the registrant are deemed to be affiliates. Such determination should not be deemed to be an admission that such officers, directors, or 10% beneficial owners are, in fact, affiliates of the registrant.

As of February 28, 2018, there were 10,109,715 shares of the registrant's common stock outstanding.

Documents Incorporated by Reference

Portions of the registrant's definitive proxy statement for the 2018 Annual Meeting of Stockholders, to be filed with the Commission within 120 days after the end of the fiscal year ended December 31, 2017, are incorporated by reference into Part III of this report.

KONA GRILL, INC.
Annual Report on Form 10-K
For the Year Ended December 31, 2017

TABLE OF CONTENTS

PART I

Item 1. Business	1
Item 1A. Risk Factors	9
Item 1B. Unresolved Staff Comments	21
Item 2. Properties	22
Item 3. Legal Proceedings	23
Item 4. Mine Safety Disclosures	23

PART II

Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	24
Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations	25
Item 7A. Quantitative and Qualitative Disclosures About Market Risk	39
Item 8. Financial Statements and Supplementary Data	39
Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure	39
Item 9A. Controls and Procedures	39
Item 9B. Other Information	40

PART III

Item 10. Directors, Executive Officers and Corporate Governance	40
Item 11. Executive Compensation	40
Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	40
Item 13. Certain Relationships and Related Transactions, and Director Independence	40
Item 14. Principal Accountant Fees and Services	41

PART IV

Item 15. Exhibits and Financial Statement Schedules	41
Signatures	43
Index to Consolidated Financial Statements	F-1

Statements Regarding Forward-Looking Statements

The statements contained in this report on Form 10-K that are not purely historical are forward-looking statements within the meaning of applicable securities laws. Forward-looking statements include statements regarding our “expectations,” “anticipation,” “intentions,” “beliefs,” or “strategies” regarding the future. Forward-looking statements relate to our future economic performance, plans and objectives for future operations, and projections of sales and other financial items are based on our beliefs as well as assumptions made by and information currently available to us. Actual results could differ materially from those currently anticipated as a result of a number of factors, including those discussed in Item 1A, “Risk Factors.”

PART I

Item 1. *Business*

Overview

Kona Grill, Inc. (referred to herein as the “Company” or “we,” “us,” and “our”) currently owns and operates 46 upscale casual restaurants in 23 states and Puerto Rico. In addition, we have three international restaurants that operate under franchise agreements. Our restaurants offer freshly prepared food, attentive service, and an upscale contemporary ambience that create an exceptional, yet affordable dining experience that we believe exceeds many traditional casual dining restaurants with whom we compete. Our restaurants feature a global menu of contemporary American favorites, award-winning sushi and craft cocktails. Our menu items are prepared from scratch at each restaurant location and incorporate over 40 signature sauces and dressings, creating memorable flavor profiles that appeal to a diverse group of customers. Our diverse menu is complemented by a full service bar offering a broad assortment of wines, craft cocktails, and beers. We believe that our innovative high-quality recipes, generous portions, and flexible price points provide customers with a compelling value proposition and allow us to attract a diverse customer base.

Our restaurants seat an average of 290 customers and are comprised of multiple dining areas that incorporate modern design elements to create an upscale ambience that reinforces our high standards of food and service. Our main dining area, full-service bar, indoor/outdoor patio, and sushi bar provide a choice of atmospheres and a variety of environments designed to attract new customers and encourage repeat visits from regular customers. We build 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 customers throughout the day.

The portability of our concept has been successfully demonstrated in a variety of markets across the United States (U.S.). Our long-term plans include strategically expanding the Kona Grill concept in both domestic and international markets. During 2017, we opened one restaurant in Scottsdale, Arizona and our franchise partners opened the first international Kona Grill restaurants in Vaughan (Toronto), Canada; Dubai, United Arab Emirates and Monterrey, Mexico.

Competitive Strengths

The restaurant business is intensely competitive with respect to food quality, price-value relationships, ambience, service and location. 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, high quality food that includes a diverse selection of contemporary American favorites and award-winning sushi items to appeal to a wide range of tastes, preferences, and price points. We prepare our dishes from scratch at each restaurant location using original recipes with generous portions and creative and appealing presentations. Our more than 40 signature sauces and dressings create memorable flavor profiles and further differentiate our menu items.

Distinctive Upscale Casual Dining Experience. Our creative menu, personalized service, and contemporary restaurant design blend together to create an inviting upscale casual dining experience. We design our restaurants with a unique layout and utilize modern, eye-catching design elements to enhance the customer experience. Our multiple dining areas provide customers with many distinct dining environments and atmospheres to suit a range of dining occasions. Our open exhibition-style kitchen and sushi bar further emphasize the quality and freshness of our food that are the cornerstones of our concept.

Significant Bar and Happy Hour Business. Our high-energy bar and patio offer a distinctive atmosphere where customers can enjoy our alcoholic beverage offerings. Our patio is a popular place for customers to enjoy our high-value happy hour and reverse happy hour offerings, where full portions of select items are offered at reduced price points. Our patio, which is enclosed in colder climate locations, provides a year-round sales opportunity and is a key driver in generating business during non-traditional periods. Aggregate revenue during these non-peak periods accounted for 23.3% of our total sales during 2017, which we believe provides us with a competitive advantage.

Personalized Customer Service. Our commitment to make every experience exceptional reinforces our upscale ambience and helps distinguish us from other casual dining restaurants. We train our service personnel to be friendly and knowledgeable about all aspects of the restaurant, which helps us provide personalized customer service that is designed to ensure an enjoyable dining experience and exceed our customers' expectations. Our kitchen staff completes extensive training to ensure that menu items are precisely prepared to provide a consistent experience. We believe our focus on high service standards underscores our customer-centric philosophy.

Multiple Daypart Model. Our appetizers, entrees, and sushi offerings provide a flexible selection of items that can be ordered individually or shared allowing customers to dine with us during traditional lunch and dinner meal periods as well as between customary dining periods such as in the late afternoon and late night. The lively ambience of our patio and bar areas provides an energetic ambience as well as provides a unique atmosphere for customers to enjoy before or after they dine with us. Our sushi bar provides another dining venue for customers while offering a wide selection of creative and flavorful menu items for health-conscious customers. We believe that our ability to attract customers throughout the day distinguishes us from many other casual dining chains.

Attractive Unit Economics. During 2017, the average unit volume of our comparable base restaurants was \$4.1 million. We believe our high average unit volume helps us attract high-quality employees, leverage fixed costs, and makes us a desirable tenant for landlords. We expect the average cash investment for new restaurants to be approximately \$2.6 million, net of landlord tenant improvement allowances and excluding preopening expenses. Based on historical experience, 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.

Growth Strategy

We have grown significantly over the past several years. Starting in 2017 we have pursued more modest growth to give our existing base of restaurants the opportunity to mature. We continue to believe that there will be significant long-term opportunities to grow our sales and increase our brand awareness throughout the United States and internationally. The following sets forth the key elements of our growth strategy.

Pursue Disciplined Restaurant Growth When Appropriate

Historically, we have reviewed potential sites in both new and existing markets that meet our target customer demographics, real estate, and investment return criteria. We believe the location of our restaurants plays a pivotal role in determining the long-term profitability of each restaurant and, accordingly, we have spent significant time and resources to evaluate each prospective site. We utilize a disciplined site selection process involving our management team and Board of Directors. Our site selection criteria for new restaurants has included selecting sites near high activity areas such as lifestyle centers. In addition, we have focused on areas that have above-average density and income populations, have high customer traffic throughout the day from thriving businesses or retail markets, and are

convenient for and appealing to business and leisure travelers. We have also focused on sites that have great visibility and ample parking to support high volumes of traffic.

Over the past four years, we have grown organically through opening new restaurants and doubled the number of domestic restaurants during this time from 23 to 46. Our unit growth rate was 22% in 2016, with eight openings during the year and we had 23% unit growth in 2015 with seven restaurant openings. We opened only one domestic restaurant in 2017. We believe that a modest growth rate over the next few years will allow us to focus our time and attention on restaurant operations and improving financial performance.

We continue to execute our strategy for international market expansion. As there is increased demand for upscale casual dining concepts overseas, we believe there is a significant opportunity to expand our concept in Canada, Latin America, the Middle East and beyond. In 2016, we signed agreements for the development of six Kona Grill restaurants in Mexico and six Kona Grill restaurants in the United Arab Emirates. In April 2017, we signed an agreement for the development of one Kona Grill restaurant in Vaughan (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. Each of our three international franchise partners opened a Kona Grill restaurant in their respective countries in the second half of 2017.

Pursue Growth in Existing Restaurant Sales

Our goal for existing restaurants is to increase unit volumes through consistent execution of our food and drink offerings; however our same store sales decreased in 2017 after six straight years of growth. We are focused on key initiatives designed to drive traffic, increase sales and enhance the customer experience while building our business for long-term growth. We have enhanced our cocktail and wine list and continue to utilize our Wine Down Wednesday offering to drive customer traffic by offering a 50% discount on bottle wines each Wednesday. We offer online ordering for the convenience of our customers and have also partnered with several companies for delivery services to drive incremental sales growth. We believe the strength of our differentiated concept and the appeal of our contemporary design enables us to gain market share. Furthermore, we continue to focus on the quality of our service and hospitality with extensive training for our service staff on our menu offerings. We continue to grow our customer loyalty program, Konavore™, which has grown to over 338,000 members. We utilize this e-mail based program to communicate new menu offerings, restaurant specific events, and other marketing messages to keep Kona Grill top of mind for consumers. We have also increased our presence in social marketing and engaging with customers through various social media.

Continue Strategic Investments in Personnel and Systems

We believe that successful execution of our growth strategies for our existing restaurants will enable Kona Grill to be a leading upscale casual dining restaurant operator in the U.S. We have made strategic personnel investments and will make incremental investments over the long-term to support the growth of the Kona Grill brand both domestically and internationally. Additionally, we continue to implement software and tools to enhance our business while ensuring that strong financial controls are in place to minimize risks associated with our growth strategy.

Unit Economics

We target a 30% net cash-on-cash return for our restaurants once they reach their mature level of operations. Maturation periods vary from restaurant to restaurant, but generally range from two to four years. The cash-based performance target for our operating restaurant operations does not include field supervision, corporate support expenses, preopening expenses, or non-cash items such as depreciation and amortization; and does not represent a targeted return on investment in our common stock.

Our investment cost for new restaurants varies significantly depending upon the location of the restaurant, the type of lease entered into and the amount of tenant improvement allowance we receive from landlords. We expect the cash investment cost of our prototype restaurant on average to be approximately \$2.6 million, net of landlord tenant improvement allowances averaging between \$0.7 million and \$1.2 million, and excluding cash preopening expenses of approximately \$450,000.

Our ability to generate sales throughout the day is a key strength of our concept. The following table depicts the amount and percentage of contribution for each daypart of overall revenues during 2017.

2017 Sales by Daypart

	Sales	Percent	
	(Dollars in thousands)		
Lunch (Open to 3 p.m.)	\$43,756	24.4	%
Dinner (5 p.m. to 9 p.m.)	93,634	52.3	%
Non-Peak (3 p.m. to 5 p.m. and 9 p.m. to Close)	41,691	23.3	%
Total All Day	\$179,081	100.0	%

Menu

Our menu features a wide selection of appetizers, salads, soups, flatbreads, sandwiches, noodles, seafood, signature entrees, and desserts. Our appetizers include socially interactive items that can be eaten individually or easily shared among customers. Our signature entrees feature various sauces and offer customers generous portions that are impressive in presentation and in taste. For example, our most popular entrée is the Macadamia Nut Chicken served with shoyu-cream sauce and accompanied by parmesan garlic mashed potatoes and seasonal vegetables. Other favorites include Miso-Sake Sea Bass served with shrimp and pork fried rice and a seasonal vegetable and Pan-Seared Ahi served with steamed white rice, baby bok choy and a sweet chili sauce.

We also offer an extensive assortment of sushi that includes traditional favorites as well as distinctive specialty sushi and sashimi items such as our Voodoo Roll made with spicy crawfish mix and avocado rolled inside of seaweed and topped with a habanero tuna mix and chili masago, or the Bama Roll made with crab mix, cream cheese and jalapeno in soy paper topped with tuna, avocado, fish roe and spicy mayo. Sushi sales accounted for 27.2% of our total revenue during 2017.

Our menu, coupled with an expansive selection of sushi, offers ample choices for health-conscious customers. We take great pride in providing our customers the full Kona Grill experience without compromising their dietary needs and restrictions. We offer extensive gluten-free, vegetarian and vegan menus. We also feature a bento box with a variety of selections of protein and side dishes for the enjoyment of our young customers.

Each of our restaurants has a dedicated kitchen staff member, whom we refer to as our saucier, to oversee the preparation of more than 40 signature sauces and dressings that are made from scratch using only high-quality ingredients and fresh products. Each sauce is designed according to a proprietary recipe for specific menu items and includes unique flavors and combinations such as our honey cilantro, shoyu-cream, and spicy aioli dipping sauces, and our sesame-soy and honey dijon salad dressings. We believe that these distinctive sauces and dressings provide a unique flavor profile, which further distinguishes Kona Grill from its competitors.

The versatility of our menu enables us to provide customers with dishes that can be enjoyed outside of the traditional lunch and dinner meal periods, as well as to serve our customers' requirements for a variety of dining occasions, including everyday dining, business lunches, social gatherings and special occasions. We also offer catering, group dining menus, and sushi platters to provide additional opportunities to serve our customers' needs. In general, our menu is consistent from location to location. We typically update our menu in the spring and the fall and make enhancements to existing items or introduce new items based on customer feedback, which helps ensure that we are meeting the needs of our customers.

Our restaurants also offer an extensive selection of bottled and draft beers, wines by the glass or bottle, sake and an extensive selection of liquors and craft cocktail drinks. Alcoholic beverage sales represented approximately 27.3% of our total revenue during 2017.

Decor and Atmosphere

We design our restaurants to offer customers a unique dining experience in a setting that is relevant for today and tomorrow. Each of our restaurants is designed with a contemporary look that is adaptable to varying real estate opportunities while incorporating signature elements such as multiple dining areas and open floor plan. Customers can expect to find a warm and inviting atmosphere that aligns with our innovative food and drink offerings and high-quality service. The layout of our restaurants focuses on creating multiple dining areas for our customers while maintaining an open atmosphere that allows customers to have a panoramic view of the entire restaurant and exhibition kitchen and sushi bar. We utilize a variety of directional lighting styles and design elements to add warmth to all dining spaces throughout our restaurants.

Regardless of the experience customers are looking for, our restaurant design offers a variety of dining experiences to fit every mood and occasion. Our indoor/outdoor patio with a full-service bar incorporates a high-energy, socially interactive atmosphere for customers to enjoy appetizers or sushi while they wait to dine with us, and serves as a destination for many of our frequent customers during the late afternoon and late-night periods. Certain of our locations offer private dining rooms for parties, special occasions and business events. Additionally, three of our restaurants feature a rooftop patio and we enclose patios in colder climates to maximize utilization of the patio throughout the year. Alternatively, our dining room provides a warm and intimate ambience for special occasions or dinner with friends and family. For sushi enthusiasts, we showcase our highly trained sushi chefs creating their masterpieces at our expansive sushi bar.

Food Preparation, Quality Control, and Purchasing

We believe that we have some of the highest food quality standards in the industry. Our standards are designed to protect food products throughout the preparation process. We provide detailed specifications to suppliers for food ingredients, products, and supplies. We strive to maintain quality and consistency in our restaurants through careful hiring, training and supervision of personnel. We require annual recertification training for all employees, and each employee receives extensive training relating to food and beverage preparation and restaurant operations. We also instruct kitchen managers and staff on safety, sanitation, housekeeping, repair and maintenance, product and service specifications, ordering and receiving products, and quality assurance. All of our restaurant managers are compliant with Hazard Analysis and Critical Control Point, or HACCP, requirements. We monitor minimum cook temperature requirements and conduct twice-a-day kitchen and food quality inspections to further assure the safety and quality of all of the items we use in our restaurants. We have a ServSafe alcohol certification program, where every front of house employee is trained and tested to ensure we are providing responsible alcohol service. Further, to monitor and ensure compliance with required guidelines, we evaluate all of our employees on their ability to maintain sanitary conditions in their respective restaurants.

We source our products and supplies with reputable and high-quality providers that are capable of providing consistent, reliable distribution to all of our restaurants. We have arrangements with national and local distributors and specialty food suppliers who provide high-quality ingredients and perishable food products. These distributors and suppliers are required to comply with food safety guidelines mandated by HACCP, the Food & Drug Administration and local statutes and regulations of the particular state, county or municipality.

Our goal is to maximize purchasing efficiencies and obtain the lowest possible prices for ingredients, products, and supplies, while maintaining the highest quality. We are committed to purchasing high-quality ingredients for our restaurants at reasonable prices. We use fresh ingredients and, as a result, we maintain only modest inventories. We believe that competitively priced alternative distribution sources are available should those channels be necessary. We negotiate national supply contracts and prices for food supply throughout all of our restaurants, monitor quality control and consistency of the food supplied to restaurants, and oversee delivery of food on a nationwide basis. In order to provide the freshest ingredients and products, and to maximize operating efficiencies between purchase and usage, we utilize an automated food cost and inventory system to assist each restaurant's management team in determining daily order requirements for food ingredients, products, and supplies. The management team orders accordingly from approved suppliers, and all deliveries are inspected to assure that the items received meet our quality specifications and negotiated prices.

Restaurant Operations

Executive and Restaurant Management

Our executive management team continually monitors restaurant operations to assure the quality of products and services and the maintenance of facilities. We have procedures to enhance efficiency, reduce costs and provide centralized and individual restaurant support systems. Our corporate operations team and directors of operation have primary responsibility for oversight of our restaurants and analyze restaurant-level performance and strategic planning. We currently employ six directors of operations who are each responsible for overseeing the restaurants in a specific region. The directors of operations' responsibilities include supporting the general managers and helping each restaurant achieve the sales and cash flow targets for their restaurant as well as providing insight for decision making in such areas as food and beverage, people development, and process improvements to enhance the efficiency of operations and the dining experience for our customers.

Our typical restaurant management team consists of a general manager, executive chef, sous chef and two to three additional managers depending upon the sales volume of each restaurant. Our restaurants employ on average approximately 75 non-management employees, many of whom work part-time. The general manager is responsible for the day-to-day operations of the restaurant, including the hiring, training, personnel development, execution of local marketing programs, and operating results. The chefs are responsible for overseeing the preparation of kitchen and sushi items, maintaining product quality, and closely monitoring food costs and department labor costs.

Training

In order to maintain quality and consistency in each of our restaurants, we carefully train and supervise restaurant personnel and adhere to high standards related to personnel performance, food and beverage preparation, and maintenance of our restaurants. All of our restaurant personnel participate in both initial and ongoing training programs under the direction of our director of training. Each restaurant manager completes a formal training program that is comprised of a mix of online and on-the-job instruction. The training covers all aspects of management philosophy and overall restaurant operations, including supervisory skills, operating and performance standards, accounting procedures, IT systems and employee selection and training necessary for top-quality restaurant operations. The training programs also involve intensive understanding of our menu and other key service protocols.

Recruitment and Retention

Our future growth and success is highly dependent upon our ability to attract, develop, and retain qualified individuals who are capable of successfully managing our high-volume, upscale casual restaurants. We believe that our high unit volume, the image and atmosphere of the Kona Grill concept, and career advancement and employee benefit programs enable us to attract high quality management and restaurant personnel. We offer restaurant management personnel competitive wages and benefits, including medical insurance and participation in our 401(k) plan with a company match. We motivate and prepare our restaurant personnel by providing them with opportunities for increased responsibility and advancement through a formal management development program. Furthermore, the management team of each restaurant shares in a bonus tied to the sales and overall profitability of their restaurant. We believe that our compensation package for managers and restaurant employees is comparable to or better than those provided by other upscale casual restaurants. We believe our compensation policies help us attract quality personnel.

Information Systems

We believe that our management information systems enable us to increase the speed and accuracy of order-taking and pricing, efficiently schedule labor to better serve customers, monitor labor costs, assist in product purchasing and menu mix management, promptly access financial and operating data, and improve the accuracy and efficiency of restaurant-level information and reporting.

We utilize an integrated information system to manage the flow of information within each of our restaurants and between each restaurant and our corporate office. This system includes a point-of-sale (POS) local area network that helps facilitate the operations of the restaurant by recording sales transactions and printing orders in the appropriate locations within the restaurant. Additionally, we utilize the POS system to authorize, batch, and transmit credit card transactions, record employee time clock information, and produce a variety of management reports. The POS is integrated with food cost and labor scheduling software as well as our accounting system and incorporates a redundancy and back-up emergency operating plan on a temporary basis if the system experiences downtime.

We transmit electronically select information that is captured from the POS system to our corporate office on a daily basis. This information flow enables senior management to monitor operating results with daily and weekly sales analysis, detailed labor and food cost information, and comparisons between actual and budgeted operating results. We continually evaluate both our restaurant information systems and corporate office information systems to enhance operations. We believe our information systems are secure and scalable as we continue to build our brand.

Advertising and Marketing

Our ongoing advertising and marketing strategy consists of a loyalty program, social media, grass-root local marketing, various public relations activities and word-of-mouth recommendations. We believe that these mediums are key components in driving customer trial and repeat usage. We have invested, and expect to continue to invest, in marketing and branding efforts, primarily to increase revenue and expand brand awareness.

We implement a coordinated public relations effort in conjunction with each new restaurant opening. Approximately 60 days before a scheduled restaurant opening, we collaborate with the local media to publicize our restaurant and generate awareness of our brand. This effort is usually supplemented by targeted marketing campaigns, social media and other marketing efforts, including hosting a high-profile event in which we invite local leaders and community members as part of our preopening practice activities to introduce our concept to the local market. In addition, we use various social media platforms and our website, www.konagrill.com, to promote brand awareness.

Competition

The restaurant industry is highly competitive. Key competitive factors in the industry include the taste, quality, and price of food and drink offerings, quality and speed of customer service, brand name recognition, attractiveness of facilities, restaurant location, customer convenience and overall dining experience.

We believe we compete favorably with respect to each of these factors, as follows:

We offer a global menu of contemporary American favorites, award-winning sushi items and specialty cocktails;

We strive to maintain quality and consistency in each of our restaurants through the careful training and supervision of restaurant personnel and adherence to high standards related to personnel performance, food and beverage preparation, and maintenance of our restaurants;

Our innovative menu with attractive price points, attentive service, and contemporary restaurant design with multiple environments blend together to create our upscale casual dining experience and enables us to attract a broad customer demographic.

We offer online ordering through our website, catering and group dining menus, and partner with third parties for delivery service of our food and drink offerings.

Although we believe we compete favorably with respect to each of these factors, there are a substantial number of restaurants and food service providers that compete directly and indirectly with us, many of which have significantly greater financial resources, higher revenue, and greater economies of scale. The restaurant business is often affected by changes in consumer tastes and discretionary spending patterns; national and regional employment statistics; demographic trends; weather conditions; the cost and availability of raw materials, labor, and energy; purchasing power; governmental regulations; and local competitive factors. Any change in these or other related factors or negative publicity relating to food safety could adversely affect our restaurant operations. Accordingly, we must constantly evolve and refine the critical elements of our restaurant concept over time to protect their longer-term competitiveness. Additionally, there is competition for highly qualified restaurant management employees and for attractive locations suitable for upscale, high volume restaurants.

Trademarks

We have registered the service marks “Kona Grill” and “Konavore” with the United States Patent and Trademark Office and “Kona Grill” in certain foreign jurisdictions. We believe that our trademarks and other proprietary rights, such as our distinctive menu offerings and signature sauce recipes, have significant value and are important to the marketing of our concept. We have protected in the past and will continue to vigorously protect our proprietary rights. We cannot predict, however, whether steps taken by us to protect our proprietary rights will be adequate to prevent misappropriation of these rights or the use by others of restaurant features based upon, or otherwise similar to, our concept. It may be difficult for us to prevent others from copying elements of our concept and any litigation to enforce our rights will likely be costly. In addition, other local restaurant companies with names similar to ours may try to prevent us from using our marks in those locales.

Government Regulation

Each of our restaurants is subject to licensing and regulation by state and local departments and bureaus of alcohol control, health, sanitation, zoning, and fire and to periodic review by state and municipal authorities for areas in which the restaurants are located. In addition, we are subject to local land use, zoning, building, planning, and traffic ordinances and regulations in the selection and acquisition of suitable sites for developing new restaurants. Delays in obtaining, or denials of, or revocation or temporary suspension of, necessary licenses or approvals could have a material adverse impact on our restaurant development.

Alcoholic beverage control regulations require each of our restaurants to apply to a state authority and, in certain locations, county and municipal authorities for a license and permit to sell alcoholic beverages on the premises. Typically, licenses must be renewed annually and may be subject to penalties, temporary suspension or revocation for cause at any time. Alcoholic beverage control regulations impact many aspects of the daily operations of our restaurants, including the minimum age of patrons and employees, hours of operation, inventory control and handling, and storage and dispensing of alcoholic beverages. We have not encountered any material problems relating to

alcoholic beverage licenses or permits to date. The failure of a restaurant to obtain or retain its liquor license would adversely affect that restaurant's operations and profitability.

We are subject to "dram shop" statutes in most of the states in which we operate. Those statutes generally provide a person who has been injured by an intoxicated person the right to recover damages from an establishment that wrongfully served alcoholic beverages to such person. We carry liquor liability coverage as part of our existing comprehensive general liability insurance which we believe is consistent with coverage in the full-service restaurant industry. Even though we carry liquor liability insurance, a judgment against us under a "dram shop" statute in excess of our liability coverage could have a material adverse effect on our operations.

Our operations are also subject to federal and state laws governing such matters as wages, working conditions, citizenship requirements, and overtime. Several states have set minimum wage rates higher than the current federal level. A significant number of hourly personnel at our restaurants are paid at rates related to state and federal minimum wage laws and, accordingly, state minimum wage increases implemented during the last several years have increased our labor costs. Increases in the minimum wage rate or the cost of workers' compensation insurance, changes in tip-credit provisions, employee benefit costs (including costs associated with mandated health insurance coverage), or other costs associated with employees could adversely affect our operating results. To our knowledge, we are in compliance in all material respects with applicable federal, state, and local laws affecting our business.

Employees

As of February 28, 2018, we employed 3,638 people of whom 3,588 worked in our restaurants and 50 were employed at our corporate office. None of our employees are covered by a collective bargaining agreement. We have never experienced a major work stoppage, strike, or labor dispute. We consider our relations with our employees to be favorable.

Access to Information

Our website is located at *www.konagrill.com*. The information on our website is not part of this filing. Through our website, we make available free of charge our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements, and any amendments to those reports filed or furnished to the Securities and Exchange Commission. These reports are available as soon as reasonably practicable after we electronically file these reports with the SEC. We also post on our website the charters of our Audit, Compensation, and Nominating Committees; Code of Business Conduct and Ethics; Code of Ethics for the Chief Executive Officer and Senior Financial Officers; Insider Trading Policy and any other corporate governance materials required by SEC or NASDAQ regulations. These documents are also available in print to any stockholder requesting a copy from our corporate secretary at our executive offices.

Item 1A. Risk Factors

Risks Related to Our Business

The impact general economic conditions have on consumer discretionary spend could negatively affect our business and results of operations.

Purchases at our restaurants are discretionary for consumers and we are therefore susceptible to economic slowdowns. We believe that consumers generally are more willing to make discretionary purchases during favorable economic conditions. Economic and political uncertainty, financial market volatility and unpredictability, and the oversupply of restaurants in the U.S can all negatively affect customer traffic and sales throughout our industry. If the economy experiences a downturn or continued uncertainties, our customers may further reduce their level of discretionary spending, impacting the frequency with which they choose to dine out or the amount they spend on meals while dining out.

There is also a risk that if uncertain economic conditions persist for an extended period of time or worsen, consumers might make long-lasting changes to their discretionary spending behavior, including dining out less frequently. The ability of the U.S. economy to handle this uncertainty is likely to be affected by many national and international factors that are beyond our control. These factors, including national, regional and local politics and economic conditions, disposable consumer income and consumer confidence, also affect discretionary consumer spending. Continued uncertainty in or a worsening of the economy, generally or in a number of our markets, and our customers' reactions to these trends could adversely affect our revenues and cause us to, among other things, reduce the number and frequency of new restaurant openings, close restaurants and delay remodeling of existing locations.

Our sales and ability to generate profits could be adversely affected if comparable restaurant sales are less than we expect, and we may not successfully increase comparable restaurant sales or they may decrease.

While future sales growth will depend substantially on opening new restaurants, changes in comparable or same-store restaurant sales will also affect our sales growth and will continue to be a critical factor in generating future profits. This is because the profit margin on comparable restaurant sales is generally higher, as comparable restaurant sales increases enable fixed costs to be spread over a higher sales base. Conversely, declines in comparable restaurant sales can have a significant adverse effect on profitability due to the loss of the positive impact on profit margins associated with comparable restaurant sales increases.

Our comparable restaurant sales decreased in 2017 after six consecutive years of increases. As our units continue in operation and new restaurants enter the comparable base, it may be more difficult to achieve significant increases in comparable restaurant sales. Further, the impact of the factors noted below may lower our expectations for comparable restaurant sales:

changes in consumer preferences and discretionary spending, including weaker consumer spending in periods of economic difficulty or uncertainty and shift of consumer spending away from shopping malls to more on-line shopping;

consumer understanding and acceptance of the Kona Grill experience and perception of the Kona Grill brand;

weather, road construction and other factors limiting access to our restaurants

competition, either from our competitors in the restaurant industry, or from our own restaurants within the same market in the event customers who frequent one of our restaurants begin to visit one of our new restaurants instead;

our ability to increase menu prices without adversely impacting customer traffic to such a degree that the impact of the decrease in customers equals or exceeds the benefit of the menu price increase;

any “trade down” by customers or other reduction in average check per person in response to price increases, which could reduce or eliminate the benefit of the price increase on comparable restaurant sales; executing our strategies effectively, including development strategy, menu improvement initiatives and marketing and branding strategies, each of which may not have the impact we expect;

turnover of key operations and restaurant personnel;

negative publicity relating to food safety or quality; and

changes in government regulation.

As a result, it is possible that we will not achieve our targeted comparable restaurant sales or that the change in comparable restaurant sales could be negative. If this were to happen, sales and profitability would be adversely affected and our stock price would likely decline. Further, many of our competitors have substantially greater financial, marketing and other resources than we do to withstand prolonged periods of declines in comparable restaurant sales and regional and national restaurant companies continue to expand their operations into our current market areas, thereby increasing competition for market share.

We depend 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 have required us to record an impairment charge for restaurants performing below expectations, and may result in future impairments.

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 customers 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, changes in demographic and economic patterns in neighborhoods and trade areas where our restaurants are located, higher frequency of online shopping, changes in discretionary consumer spending, changes in gasoline prices, or otherwise. Several shopping malls experienced declining consumer traffic in recent years. If visitor rates to these centers continue to decline, our unit volumes could decline and adversely affect our results of operations. We recorded long-lived asset impairment charges of \$9.3 million and \$12.5 million, for the years ended December 31, 2017, and 2016 respectively. Such amounts are included in "Asset impairment charge" in the Consolidated Statements of Comprehensive Loss. See Note 2 in the Notes to the Consolidated Financial Statements for further details on the impairment charges. We may be required to record impairment charges in the future if our restaurants perform below expectations.

Our failure to satisfy financial covenants and/or repayment requirements under our credit facility could harm our financial condition which could materially adversely affect our financial performance.

We have a secured credit facility consisting of a \$25 million revolver and a \$15 million term loan (collectively, the “credit facility”). As of December 31, 2017, we had \$37.8 million outstanding under the credit facility. The credit facility requires us to maintain certain financial covenants. At December 31, 2017, we were not in compliance with these covenants and the credit facility was subsequently amended to alter the financial covenants so that the financial covenants were met as of December 31, 2017. However, any failure to maintain these financial covenants or have sufficient liquidity to repay principal payments when due or the then outstanding balance at the expiration of the credit facility, or upon violation of the covenants, would materially adversely affect our financial condition and performance. There can be no assurance that in the future the Company will be in compliance with all covenants or that its lenders would waive any violations of such covenants. Non-compliance with debt covenants by the Company could have a material adverse effect on the Company’s business, results of operations and financial condition and impact our ability to continue as a going concern.

Our failure to meet operating performance expectations could result in serious doubt about our ability to remain a going concern.

The financial statements included in this report have been prepared assuming the Company will continue as a going concern. The Company has incurred losses resulting in an accumulated deficit of \$79.7 million, has a net working capital deficit of \$7.6 million and outstanding debt of \$37.8 million as of December 31, 2017. These conditions together with recent debt covenant violations and subsequent debt covenant waivers and debt amendments, raise substantial doubt about the Company’s ability to continue as a going concern. The ability to continue as a going concern is dependent upon the Company generating profitable operations, improving liquidity and reducing costs to meet its obligations and repay its liabilities arising from normal business operations when they become due. The Company has evaluated its plans to alleviate this doubt, which will include slowing new restaurant development, implementing cost-savings initiatives and evaluating potential closure of underperforming restaurants. While the Company believes that its existing cash and cash equivalents as of December 31, 2017, coupled with its anticipated cash flow generated from operations, will be sufficient to meet its anticipated cash requirements, there can be no assurance that the Company will be successful in its plans to increase profitability or to obtain alternative financing on acceptable terms, when required or if at all. If such plans are not realized, the Company may be forced to limit its business activities or be unable to continue as a going concern, which will have a material adverse effect on our results of operations and financial condition. These financial statements included in this report do not include any adjustments to the recoverability and classification of recorded asset amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern.

Our future financial growth depends in part on our ability to open new restaurants and operate them profitably, and if we are unable to successfully execute this strategy, our results of operations could be adversely affected.

Our financial success depends in part on management's ability to execute our growth strategy. One key element of our growth strategy is opening new restaurants. After opening eight restaurants during 2016, we opened only one restaurant during 2017. Our current plans are for modest growth over the next few years as we focus on improving the profitability of our existing restaurants. Our ability to open new restaurants and operate them profitably is dependent upon a number of factors, many of which are beyond our control, including:

finding quality sites, competing effectively to obtain quality sites and reaching acceptable agreements to lease sites;

complying with applicable zoning, land use and environmental regulations and obtaining, for an acceptable cost, required permits and approvals;

having adequate capital for construction and opening costs and efficiently managing the time and resources committed to building and opening each new restaurant;

timely hiring and training and retaining the skilled management and other employees necessary to meet staffing needs;

successfully promoting our concept and competing in new markets;

acquiring food and other supplies for new restaurants from local suppliers; and

addressing unanticipated problems or risks that may arise during the development or opening of a new restaurant or entering a new market.

We have opened and intend 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. Accordingly, sales at restaurants opening in new markets may take longer to achieve or may not achieve average unit volumes comparable with our existing restaurants.

Additionally, a new restaurant typically experiences a “ramp-up” period of approximately 18 months or more before it achieves our targeted level of performance. This is due to the costs associated with opening a new restaurant, as well as higher operating costs caused by start-up and other temporary inefficiencies associated with opening new restaurants. For example, there are a number of factors which may impact the amount of time and money we commit to the construction and development of new restaurants, including landlord delays, shortages of skilled labor, labor disputes, shortages of materials, delays in obtaining necessary permits, local government regulations and weather interference. Once the restaurant is open, how quickly it achieves a desired level of profitability is impacted by many factors, including the level of market familiarity and acceptance when we enter new markets, as well as the availability of experienced staff and the time required to negotiate reasonable prices for services and other supplies from local suppliers. Our business and profitability may be adversely affected if the “ramp-up” period for a new restaurant lasts longer than we expect.

To the extent that we open new restaurants, we 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 or our ability to open new restaurants on a timely basis after we have identified sites. Our long-term goal is to strategically expand the Kona Grill concept in both new and existing markets.

There can be no assurance that any unit growth goal will be realized because our ability to open new restaurants 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;

difficulty negotiating leases with acceptable terms;

cash flow generated by our existing restaurants;

delay or cancellation of new site development by developers and landlords, which may become increasingly common during periods of economic uncertainty;

difficulty managing construction and development costs of new restaurants at affordable levels, particularly in competitive markets;

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;

obstacles to hiring and training qualified operating personnel in the local market, especially in highly competitive hiring environment;

inclement weather, impact of climate change, natural disasters and other calamities; and

general economic conditions.

Any deterioration in general economic conditions could have a material adverse impact on our landlords or on businesses neighboring our locations, which could adversely affect our revenues and results of operations.

Any deterioration in general economic conditions could result in our landlords being unable to obtain financing or remain in good standing under their existing financing arrangements which could result in their failure to satisfy obligations to us under leases, including failures to fund or reimburse agreed-upon tenant improvement allowances. Any such failure could adversely impact our operations. Our restaurants are generally located in retail developments with nationally recognized co-tenants, which help increase overall customer traffic into those retail developments. Some of our co-tenants have or may cease operations in the future or have deferred openings or fail to open in a retail development after committing to do so. These failures may lead to reduced customer traffic and a general deterioration in the surrounding retail centers in which our restaurants are located and may contribute to lower customer traffic at our restaurants. If these retail developments experience high vacancy rates, we could experience decreases in customer traffic. As a result, our results of operations could be adversely affected.

Closing restaurants or terminating leases could adversely impact our cash flow.

We enter into long-term leases, usually with ten year terms. To the extent that we must close a restaurant because of poor economic performance, or to the extent that we do not develop a restaurant for which we have signed a lease, we may be required to expend significant financial resources to terminate such lease. Further, poor operating results at any one restaurant or a delay or cancellation in the planned opening of a restaurant could materially affect the financial performance for a particular period and perception of our company, making the investment risks related to any one location more significant than those associated with larger restaurant companies who have substantially greater financial and other resources.

Due to our small base of existing restaurants and the significant expenses required to open new restaurants, any decision to either reduce or accelerate the pace of openings may cause our future operating results to fluctuate significantly and affect our comparative financial performance.

Our preopening expenses have historically been significant. The amount of such expenses incurred in any one year or quarter is dependent on the number of restaurants expected to be opened during that time period. We expect the cash investment cost of our prototype restaurant on average to be approximately \$2.6 million, net of landlord tenant improvement allowances averaging between \$0.7 million and \$1.2 million and excluding approximately \$450,000 on average in cash preopening expenses. Actual costs may vary significantly depending upon a variety of factors, including the site and size of the restaurant and conditions in the 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 sales volumes of our new restaurants may cause our results of operations to fluctuate significantly.

Adverse weather conditions, impact of climate change and natural disasters could adversely affect our results of operations. Additionally, we may not be able to obtain insurance at reasonable rates for natural disasters and other events which are beyond our control.

Adverse weather conditions can impact customer traffic at our restaurants, cause the temporary underutilization of outdoor patio seating and in more severe cases such as hurricanes, tornadoes and other natural disasters, cause temporary closures, sometimes for prolonged periods, which would negatively impact our revenue. Increasing frequency and unpredictability of adverse weather conditions due to climate change may result in decreased customer traffic. Changes in weather could result in interruptions to the availability of utilities, and shortages or interruption in the supply of food items and other supplies, which could increase our costs and negatively impact our operations.

Additionally, although we insure our restaurants against wind, flood, and other disasters, 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 effect on our results of operations.

Our domestic and international franchise growth may strain our infrastructure and resources, which could adversely affect our ability to manage our existing restaurants.

Managing our existing operations and planning for long-term growth along with supporting our international franchise partners with their new restaurant openings will increase demands on our available cash resources, as well as demands on our management team, restaurant management systems and resources, financial controls and information systems. These increased demands may adversely affect our ability to open new restaurants and to manage and when appropriate, remodel 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 growth rate and operating results could be adversely affected.

We may not be successful in our international franchise initiative or such expansion may adversely affect our financial performance.

We are expanding into international markets, initially in Mexico, the United Arab Emirates and Canada where we have executed development agreements. Similar to other brands with an international presence, we are utilizing a franchise model for development outside of the U.S., providing training and operational support to our partners without committing, or putting at risk, capital for restaurant construction in these international markets. It takes time for us to identify franchise partners and negotiate franchise agreements and for our partners to find quality real estate and construct the restaurants. We then need to train the local team on our food and hospitality standards to ensure a successful execution of our strategy.

As we continue to pursue our international market expansion, we may not be fully aware of the significant development efforts involved and barriers to entry into these markets. Accordingly, even though we are attempting to manage the necessary capital investment through the utilization of the franchise model, we may incur more expenses than originally anticipated and our investment may take additional time to come to fruition. Furthermore, there is a risk that we may not be successful in our international business development efforts. In that case, we may not be able to recover all of the investments incurred. Additionally, our attempt to expand internationally could result in significant distraction or diversion of resources from our existing operations in the U.S.

There is no assurance that we will find the proper franchisees to successfully expand internationally, or that the franchised restaurants in foreign markets will gain market acceptance or be able to operate on a profitable basis. Our international operations are subject to many of the same risks associated with our domestic operations, as well as a number of additional risks. These include, among other things, international economic and political conditions, and differing cultures and consumer preferences.

Our international expansion and global brand development efforts could negatively affect our brand or could result in sanctions or liability for violations of regulations or legal actions.

Our business expansion into international markets could create new risks to our brand and reputation. We believe that we will be able to select high-caliber international operating partners with significant experience; however, there is risk that our brand value or financial results could be harmed by factors outside of our control, including, but not limited to:

difficulties in achieving the consistency of product quality and service as compared to restaurants we operate in the U.S.;

changes to our recipes and beverages due to cultural differences;

inability to obtain adequate and reliable supplies of ingredients and products necessary to execute our diverse menu;
and

differences, changes or uncertainties in economic, regulatory, legal, social and political conditions.

Further, as we expand our brand internationally, we must comply with regulations and legal requirements, including those related to the protection of our trademarks, trade secrets and other intellectual property - see “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” below. We will have additional exposure to foreign tax laws and regulations. Additionally, we will need to comply with both domestic laws affecting U.S. businesses that operate internationally and foreign laws in the countries in which we expand our restaurants, such as the Foreign Corrupt Practices Act, under which we have not had exposure prior to our international expansion. Failure to comply with any such legal requirements could subject us to monetary liabilities and other sanctions. Also, we may become subject to lawsuits or other legal actions resulting from the acts or omissions of our operating partners and, even though we may have taken reasonable steps to protect against such liabilities, including by obtaining contractual indemnifications and insurance coverage, there is no assurance that we will not incur liability that is not covered by such protection, or incur costs and expenses as a result of our operating partners’ conduct even when we are not legally liable. Any of these risks could harm our business, results of operations and financial condition.

Failure to attract, retain and motivate effective leaders and the loss of key personnel could negatively impact our business.

Our future success is highly dependent upon our ability to attract and retain key management and operations personnel. We must be able to attract, retain and motivate a sufficient number of qualified management and operations personnel, including culinary and training personnel, directors of operations, general managers and executive chefs. Our executive officers provide a vision for our company, execute our business strategy, and maintain consistency in the operating standards of our restaurants. The ability of key management and operations personnel to maintain consistency in the quality and diversity of our menu offerings as well as service and hospitality for customers is a critical factor in our future success. Any failure to attract, retain, and motivate key personnel may harm our reputation and result in a loss of 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. Additionally, 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.

Furthermore, we have not registered all of our trademarks and service marks throughout the world as doing so may not be feasible because of associated costs or various foreign trademark law prohibitions. Our inability to effectively protect our intellectual property domestically or internationally may result in limiting our ability to globally expand our brand thereby adversely affecting our financial performance.

Our business could be adversely impacted if our information technology and computer systems do not perform properly or if we fail to protect our customers' or our employees' information. Additionally, the inappropriate use of social media vehicles could harm our reputation and adversely impact our business.

We rely heavily on information technology to conduct our business, including point-of-sale processing in our restaurants, management of our supply chain, collection of cash, payment of obligations and various other processes and procedures. Our ability to efficiently manage our business depends significantly on the reliability and capacity of these systems. Any material failure, interruption of service, or compromised data security, problems with maintenance, upgrading or transitioning to replacement systems or a breach in security of these systems could cause delays in customer service and reduce efficiency in our operations and could otherwise adversely affect our operations. While we take data security very seriously and expend significant resources to ensure that our information technology operates securely and effectively, any security breaches could result in disruptions to operations or unauthorized disclosure of confidential information, and significant capital investments might be required to remediate such security breaches.

Additionally, we rely on search engine marketing and social media platforms to attract and retain customers as part of our marketing efforts. A variety of risks are associated with the use of social media, including the improper disclosure of proprietary information, negative comments about our company, exposure of personally identifiable information, fraud, or outdated information. The inappropriate use of social media vehicles by our customers or employees could increase our costs, lead to litigation or result in negative publicity that could damage our reputation.

A data security breach involving a customer's or employee's personal data could have a material adverse effect on our business, could adversely affect our reputation and could result in litigation against us or the imposition of penalties, which could adversely affect our financial performance.

We receive and maintain certain personal information about our customers and employees. For example, we transmit confidential credit card information in connection with credit card transactions, and we are required to collect and maintain certain personal information in connection with our employment practices, including the administration of our benefit plans. The collection and use of this information by us is regulated at the federal and state levels, and the regulatory environment related to information security and privacy is increasingly demanding. In addition, our ability to accept credit cards as payment in our restaurants and for on-line gift card orders depends on us remaining compliant with standards set by the PCI Security Standards Council. If our security and information systems are compromised or our employees or authorized third parties fail to comply with these laws and regulations and this information is obtained by unauthorized persons or used inappropriately, it could adversely affect our reputation and could result in litigation against us or the imposition of penalties, which could have a material adverse effect on our financial performance.

These standards require certain levels of system security and procedures to protect our customers' credit card and other personal information. We utilize both internal resources and external consultants to reduce the likelihood of any security failures or breaches. However, we can provide no assurance that these security measures will be successful. If these security measures are not successful, we may become subject to litigation against us or the imposition of regulatory penalties, which could result in negative publicity and significantly harm our reputation, any of which could have a material adverse effect on our financial performance. As privacy and information security laws and regulations change, we may incur additional costs to ensure that we remain in compliance, which could have a material adverse effect on our financial performance.

Risks Related to the Restaurant Industry

Changes in food and supply costs could adversely affect our results of operations.

Our profitability depends in part on our ability to anticipate and react to changes in food and supply costs. Like all restaurant companies, we are susceptible to increases in food costs as a result of factors beyond our control, such as general economic conditions, seasonal fluctuations, weather conditions, demand, food safety concerns, product recalls and government regulations. Although we can purchase certain commodities under contract, we currently do not use financial management strategies or have long-term contracts in place for the majority of commodities to reduce our exposure to price fluctuations. Changes in the price or availability of seafood, poultry, beef, grains, dairy or produce could affect our ability to offer a broad menu and price offering to customers and could reduce our operating margins and adversely affect our results of operations. We may not be able to anticipate and react to changing food costs through our purchasing practices and menu price adjustments in the future, and failure to do so could negatively

impact our sales and results of operations.

Changes in governmental regulation may adversely affect our ability to maintain our existing and future operations and to open new restaurants.

We are subject to the Fair Labor Standards Act (which governs such matters as minimum wages, overtime and other working conditions), along with the Americans with Disabilities Act, the Immigration Reform and Control Act of 1986, various family leave mandates and a variety of other laws enacted, or rules and regulations promulgated by federal, state and local governmental authorities that govern these and other employment matters, including tip credits, working conditions, safety standards and immigration status. We expect increases in payroll expenses as a result of federal and state mandated increases in the minimum wage, and although such increases are not expected to be material, we cannot assure you that there will not be material increases in the future. Enactment and enforcement of various federal, state and local laws, rules and regulations on immigration and labor organizations may adversely impact the availability and costs of labor for our restaurants in a particular area or across the United States. Other labor shortages or increased employee turnover could also increase labor costs. In addition, our vendors may be affected by higher minimum wage standards or availability of labor, which may increase the price of goods and services they supply to us.

We offer eligible full-time salaried employees and eligible variable-hour employees the opportunity to enroll in healthcare coverage subsidized by us. We adopted a qualifying plan under the Affordable Care Act for our eligible variable-hour employees, which has increased our labor costs. It is also possible that recent changes in the healthcare plans we offer could make us less attractive to our current or potential employees. Additionally, the Affordable Care Act has imposed additional administrative costs on us, and those costs may increase over time. The costs and other effects of the Affordable Care Act and potential changes to healthcare requirements cannot be determined with certainty, but they may have a material adverse effect on our financial and operating results.

We are also subject to laws and regulations, which vary from jurisdiction to jurisdiction, relating to nutritional content and menu labeling. Compliance with these laws and regulations may lead to increased costs and operational complexity, changes in sales mix and profitability, and increased exposure to governmental investigations or litigation. We cannot reliably anticipate any changes in customer behavior if we alter our recipes to comply with such laws and regulations. This could have adverse effects on our sales or results of operations.

Furthermore, we are subject to federal and state environmental regulations, and although these have not had a material negative effect on our operations, we cannot ensure that there will not be a material negative effect in the future. In particular, the U.S. has increased focus on environmental matters such as climate change, greenhouse gases and water conservation. This increased focus may lead to new initiatives directed at regulating an as yet unspecified array of environmental matters. These efforts could result in increased taxation or in future restrictions on or increases in costs associated with food and other restaurant supplies, transportation costs and utility costs, any of which could decrease our operating profits and/or necessitate future investments in our restaurant facilities and equipment to achieve compliance. Further, more stringent and varied requirements of local and state governmental bodies with respect to zoning, land use and environmental factors could delay, prevent or make cost prohibitive the continuing operations of an existing restaurant or the development of new restaurants in particular locations.

The impact of current laws and regulations, the effect of future changes in laws or regulations that impose additional requirements and the consequences of litigation relating to current or future laws and regulations, or our inability to respond effectively to significant regulatory or public policy issues, could increase our compliance and other costs of doing business and therefore have an adverse effect on our results of operations. Failure to comply with the laws and regulatory requirements of federal, state and local authorities could result in, among other things, revocation of required licenses, administrative enforcement actions, fines and civil and criminal liability. Compliance with these laws and regulations can be costly and can increase our exposure to litigation or governmental investigations or proceedings.

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 may open restaurants in the future, 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 27.3% of our sales during 2017. 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.

A failure to maintain food safety throughout the supply chain and food-borne illness concerns may have an adverse effect on our business.

Food safety is a top priority, and we dedicate substantial resources to ensuring that our guests enjoy safe, quality food products. However, food safety issues could be caused at the point of source or by food suppliers or distributors and, as a result, may be out of our control. In addition, regardless of the source or cause, any report of food-borne illnesses such as E. coli, hepatitis A, trichinosis or salmonella, and other food safety issues including food tampering or contamination, at one of our restaurants could adversely affect the reputation of our brand and have a negative impact on our sales. Even instances of food-borne illness, food tampering or food contamination occurring solely at restaurants of our competitors could result in negative publicity about the food service industry generally and adversely impact our sales and could result in stricter government regulation, which could increase our costs. The occurrence of food-borne illnesses or food safety issues could also adversely affect the price and availability of affected ingredients, resulting in higher costs and lower margins.

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 may not achieve profitability.

Litigation concerning our food quality, 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 customers 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. We are currently engaged in litigation in Minnesota with respect to that state's tip pooling statutes. Although the Company is in the early stages of discovery and does not expect the result of such complaint to have a material adverse effect on the Company, there is no assurance that any adverse ruling or settlement in that matter would not have a material impact on the Company's cash position and operations. 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 managers and kitchen managers, necessary to continue our operations. This ability is especially critical to our company because of our relatively small number of existing restaurants. 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 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 and other 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 generate enough operating efficiencies or increase our menu prices proportionately in order to mitigate these increased costs, 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 the following:

actual or anticipated fluctuations in our quarterly or annual financial results;

the financial guidance and growth projections we may provide to the public, any changes in such guidance and projections, or our failure to meet such guidance and projections;

failure to maintain certain financial covenants and remain in compliance with these covenants under our credit facility.

the failure of industry or securities analysts to maintain coverage of our company, changes in financial estimates by any industry or securities analysts that follow our company, or our failure to meet such estimates;

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

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

changes in consumer preferences or spending;

various market factors or perceived market factors, including rumors, whether or not correct, involving us, our customers, our strategic partners, or our competitors;

sales, or anticipated sales, of large blocks of our stock, including short selling by investors;

additions or departures of key personnel;

regulatory or political developments;

litigation and governmental or regulatory investigations;

acquisitions or strategic alliances by us or by our competitors; and

general economic, political, and financial market conditions or events.

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 the 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.

Two of our independent directors and our chief executive officer together currently own 27.4% of our outstanding common stock. As a result, these investors may have significant influence over a 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 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 December 31, 2017, we had outstanding 10,109,715 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 1,661,126 shares available for issuance under our stock award and employee stock purchase plans. 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.

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 viewed to 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. Delaware law also imposes conditions on the voting of "control shares" and on certain business combination transactions with "interested stockholders." In addition, our certificate of incorporation 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. These provisions may also limit the ability of stockholders to approve transactions that they may deem to be in their best interests.

We have a stockholder rights plan (known as a “poison pill”) which could affect our common stock price and make it more difficult for a potential acquirer to purchase a large portion of our securities, to initiate a tender offer or a proxy contest, or to acquire us.

In September 2016, our Board of Directors adopted a Stockholder Rights Plan, commonly known as a “poison pill,” with a term through September 2019. This poison pill may discourage, delay or prevent a third party from acquiring a large portion of our securities, initiating a tender offer or proxy contest, or acquiring us through an acquisition, merger or similar transaction even if our stockholders might receive a premium for their stock over the then-current market price in the event of such transaction.

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.

If we are unable to maintain effective internal control over financial reporting in the future, the accuracy and timeliness of our financial reporting may be adversely affected.

Pursuant to Section 404 of the Sarbanes-Oxley Act, we are required to furnish a report on our internal control over financial reporting. The report contains, among other matters, an assessment of the effectiveness of our internal control over financial reporting as of the end of each fiscal year, including a statement as to whether or not our internal control over financial reporting is effective. This assessment must include disclosure of any material weaknesses in our internal control over financial reporting identified by management.

While we have determined that our internal control over financial reporting was effective as of December 31, 2017, as indicated in our Management's Annual Report on Internal Control over Financial Reporting included in this Annual Report on Form 10-K, we must continue to monitor and assess our internal control over financial reporting. If our management identifies one or more material weaknesses in our internal control over financial reporting and such weakness remains uncorrected at fiscal year-end, we will be unable to assert such internal control is effective at fiscal year-end. If we are unable to assert that our internal control over financial reporting is effective at fiscal year-end, we could lose investor confidence in the accuracy and completeness of our financial reports, which could have a material adverse effect on our reputation and the price of our common stock.

Item 1B. *Unresolved Staff Comments*

Not applicable.

Item 2. Properties

We currently operate 46 restaurants in 23 states and Puerto Rico. Each of our restaurants and our corporate office are located in a leased facility. As of December 31, 2017, our restaurant leases had expiration dates ranging from 2018 to 2029, typically with options to renew for at least a five-year period. The average interior square footage of our restaurants is approximately 7,200 square feet. Many of our restaurants also have either enclosed patios or outdoor patios that are utilized when weather conditions permit. The following table sets forth our current restaurant locations and corporate office.

State	City	Location	Year Opened
Arizona	Scottsdale	Scottsdale Fashion Square	1998
Arizona	Chandler	Chandler Fashion Center	2001
Missouri	Kansas City	Country Club Plaza	2002
Nevada	Las Vegas	Boca Park Fashion Village	2003
Colorado	Denver	Cherry Creek Mall	2004
Nebraska	Omaha	Village Pointe	2004
Indiana	Carmel	Clay Terrace	2004
Texas	San Antonio	The Shops at La Cantera	2005
Texas	Dallas	North Park Mall	2006
Illinois	Lincolnshire	Lincolnshire Commons	2006
Texas	Houston	Houston Galleria	2006
Illinois	Oak Brook	Oak Brook Promenade	2006
Texas	Austin	The Domain	2007
Michigan	Troy	Big Beaver Road	2007
Connecticut	Stamford	Stamford Town Center	2007
Louisiana	Baton Rouge	Perkins Rowe	2007
Arizona	Gilbert	San Tan Village	2008
Arizona	Phoenix	City North	2008
Virginia	Richmond	West Broad Village	2009
New Jersey	Woodbridge	Woodbridge Conference Center	2009
Minnesota	Eden Prairie	Windsor Plaza	2009
Florida	Tampa	MetWest International	2009
Maryland	Baltimore	Downtown Baltimore	2010
Idaho	Boise	The Village at Meridian	2013
Texas	The Woodlands	The Woodlands Town Center	2013
Texas	Fort Worth	West 7 th	2014
Texas	El Paso	Fountains at Farah	2014
Florida	Sarasota	University Town Center	2014
Georgia	Alpharetta	Avalon	2014
Ohio	Columbus	Easton Town Center	2014
Puerto Rico	San Juan	Mall of San Juan	2015
Texas	Plano	West Plano Village	2015
Virginia	Arlington	Rosslyn-Ballston Corridor	2015

Edgar Filing: KONA GRILL INC - Form 10-K

Florida	Miami	Dolphin Mall	2015
Ohio	Cincinnati	Liberty Center	2015
Nevada	Las Vegas	Fashion Show Mall	2015
Texas	Friendswood	Baybrook Mall	2015
Alabama	Huntsville	Bridge Street Town Centre	2016
Hawaii	Honolulu	International Market Place	2016
Tennessee	Franklin	CoolSprings Galleria	2016
Virginia	Fairfax	Fair Oaks Mall	2016
Minnesota	Minnetonka	Ridgedale Center	2016
California	Irvine	Irvine Spectrum Center	2016
Florida	Winter Park	Lakeside Crossing	2016
Texas	San Antonio	North Star Mall	2016
Arizona	Scottsdale	Scottsdale Quarter	2017
Arizona	Scottsdale	Corporate Office at Scottsdale Quarter	2017

Item 3. Legal Proceedings

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

On December 13, 2012, Frank Neal Goss filed a lawsuit against Kona Grill Macadamia, Inc., a wholly-owned subsidiary of the Company (“Macadamia”) and Anthony DeAngelo in the Circuit Court of Jackson County, Kansas City, Missouri. The claim revolves around a fight that Goss and DeAngelo allegedly had outside of the Company’s Kansas City restaurant on March 1, 2011, which is claimed to have resulted in physical injury to the plaintiff. The plaintiff also claims that Macadamia failed to take certain actions that allegedly would have prevented the fight. A default judgment of approximately \$3.5 million was entered on December 18, 2013 against Macadamia, but was subsequently set aside by order of the Circuit Court on April 7, 2014. On August 17, 2015, 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. In January 2018, a confidential general release was signed by the plaintiff. On January 29, 2018, the Circuit Court dismissed the case with prejudice.

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 investigated the claims made in the letter and determined that the Plan amendment did not receive sufficient votes to adopt the amendment in accordance with the Company’s bylaws. The Company has determined which stock options granted by the Company since April 2015 were not within the number of shares reserved under the Plan prior to the 2015 amendment (the “Excess Stock Options”). All of the Excess Stock Options were issued in 2016 and 2017 to an aggregate of 13 employees and directors at exercise prices of \$14.26 and \$8.15 per share, far in excess of the current trading price of \$2.05. The Company also determined that none of the Excess Stock Options have been exercised. The Company has entered into amendments with each of the 11 holders of Excess Stock Options who are still employees or directors of the Company. The amendments specify that such Excess Stock Options cannot be exercised until further stockholder approval is obtained for an amendment to the Plan that increases the authorized shares. Therefore, the Company believes it has taken appropriate 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, if Nasdaq does not agree that necessary corrective action has been taken.

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. On October 25, 2017, the plaintiff amended the complaint to withdraw the national class claims and other common law claims, leaving one claim on behalf of a putative Minnesota class, and added a second named Plaintiff, Tracy Fortman. On January 9, 2018, a pre-trial scheduling order was issued by the District Court, setting pre-trial dates and setting a trial date of January 1, 2019. The Company is in the early stages of discovery and does not expect the result of such complaint to have a material adverse effect on the Company. However, there is no assurance that any adverse ruling or settlement in that matter would not have a material impact on the Company's cash position and operations.

On November 29, 2017, Continental Atrium Corporation filed a complaint for damages in the Superior Court for the State of California for the County of Los Angeles alleging, among other things, that the Company breached its written contract relating to the Company's decision in April 2017 to not move forward with the construction of a restaurant in El Segundo as discussed in Note 10 below (the "Complaint"). The Complaint alleges that beginning no later than August 15, 2017, the Company has failed to pay rent and other amounts owed to the plaintiff. A case management conference is scheduled for April 30, 2018. As of December 31, 2017, we had \$1.0 million in lease termination and exit costs recorded in accrued expenses in the accompanying Consolidated Balance Sheets associated with this matter.

Item 4. *Mine Safety Disclosures*

Not applicable.

PART II

Item 5. *Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities*

Market Information

Our common stock has traded on the NASDAQ Global Market under the symbol KONA since our initial public offering on August 16, 2005. The following table sets forth high and low sale prices of our common stock for each calendar quarter indicated as reported on the NASDAQ Global Market.

	High	Low
2017		
First quarter	\$12.85	\$5.80
Second quarter	\$6.35	\$3.25
Third quarter	\$4.30	\$1.50
Fourth quarter	\$3.95	\$1.70
2016		
First quarter	\$16.71	\$12.09
Second quarter	\$14.08	\$10.34
Third quarter	\$14.09	\$9.99
Fourth quarter	\$13.50	\$10.05

On February 28, 2018, the closing sale price of our common stock was \$1.80 per share. On February 28, 2018, there were 17 holders of record of our common stock.

Recent Sales of Unregistered Securities

None.

Dividend Policy

We have not paid any dividends to holders of our common stock since our initial public offering and do not anticipate that we will pay any dividends to holders of our common stock in the foreseeable future, but instead we currently plan to retain any earnings to finance our restaurant operations and the growth of our business. Payments of any cash dividends in the future, however, is within the discretion of our Board of Directors and will depend on our financial condition, results of operations, and capital and legal requirements as well as other factors deemed relevant by our Board of Directors.

Issuer Purchase of Equity Securities

In November 2015, our Board of Directors authorized a repurchase program of up to \$10 million of outstanding common stock. We completed the \$10 million stock repurchase program in June 2016 with the purchase and retirement of 832,937 shares under the 2015 authorization.

In October 2016, our Board of Directors authorized an additional stock repurchase of up to \$5 million of outstanding common stock. We completed the \$5 million stock repurchase program in February 2017 with the purchase and retirement of 532,376 shares.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis should be read in conjunction with our consolidated financial statements and related notes contained elsewhere in this report. This discussion contains forward-looking statements that involve risks, uncertainties, and assumptions. Our actual results may differ materially from those currently anticipated as a result of a variety of factors, including those set forth under Item 1A, "Risk Factors" and elsewhere in this report.

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 and doubled the number of domestic restaurants during this time from 23 to 46. Our unit growth rate was 22% in 2016, with eight openings during the year and we had 23% unit growth in 2015 with seven restaurant openings. We opened one restaurant in 2017. We believe that a modest growth rate over the next few years will allow us to focus our time and attention on restaurant operations and improving financial performance.

During the years ended December 31, 2017 and 2016, we recorded non-cash asset impairment charges of \$9.3 million and \$12.5 million, respectively, 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. During 2017, we executed lease amendments for rent concessions for five of our existing restaurants. We continue to negotiate with our landlords regarding rent abatement or closures of underperforming restaurants as part of our strategy to improve financial performance.

As part of our capital allocation strategy, during the second quarter of 2017, we made the decision to not move forward with the planned construction and opening of a restaurant in El Segundo, California and recognized \$1.4 million related to estimated lease termination and exit costs. See "Lease Termination and exit costs" in Note 10 of the Notes to the Consolidated Financial Statements for further discussion.

Cost of sales, labor, and other operating expenses for our restaurants open at least 12 months generally trend consistently with revenue, and we analyze those costs as a percentage of revenue. 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 revenue to be higher when we open a new restaurant, but to decrease as a percentage of revenue 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 revenue, which we expect will continue until these restaurants mature.

We continue to execute our strategy for international market expansion. As there is increased demand for upscale casual dining concepts overseas, we believe there is a significant opportunity to expand our concept in Canada, Latin America, the Middle East and beyond. In 2016, we signed agreements for the development of six Kona Grill restaurants in Mexico and six Kona Grill restaurants in the United Arab Emirates. In April 2017, we signed an agreement for the development of one Kona Grill restaurant in Vaughan, 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. Each of our three international franchise partners opened a Kona Grill restaurant in their respective countries in the second half of 2017.

Key Measures We Use to Evaluate Our Company

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

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 revenue 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 revenue 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.

Key Financial Definitions

Revenue. Revenue include gross food and beverage sales, net of promotions and discounts and franchise-related revenues.

Cost of Sales. Cost of sales consists of food and beverage costs and related delivery fees.

Labor. Labor includes all direct and indirect labor costs incurred in operations.

Occupancy. Occupancy includes all rent payments associated with the leasing of real estate, including base, percentage and straight-line rent, real estate taxes, and common area maintenance expense. We record tenant improvement allowances as a reduction of occupancy expense over the term of the lease.

Restaurant Operating Expenses. Restaurant operating expenses consist of all other restaurant-level operating costs, the major components of which are utilities, credit card fees, advertising, supplies, marketing, repair and maintenance, and other expenses. Other operating expenses contain both variable and fixed components.

General and Administrative. General and administrative includes all corporate and administrative functions that support operations and provide infrastructure to facilitate our future growth. Components of this category include management and staff salaries, bonuses, stock-based compensation and related employee benefits, travel, information systems, corporate rent, professional and consulting fees, and corporate insurance costs.

Preopening Expense. Preopening expense consists of costs incurred prior to opening a new restaurant and is comprised principally of manager salaries, payroll and related training costs for new employees, including food and beverage costs associated with practice and rehearsal of service activities, and rent expense incurred from the date we obtain possession of the property until opening. We expense restaurant preopening expenses as incurred. We expect preopening expenses to commence six to eight months prior to a restaurant opening. Although the actual preopening expenses for a particular location depend upon numerous factors, our historical cash preopening expenses average approximately \$450,000 per location, and non-cash preopening rent expense typically ranges from \$50,000 to \$100,000 per location. Preopening costs will fluctuate from period to period depending upon the number of restaurants opened, the timing of new restaurant openings, the location of the restaurants, and the complexity of the staff hiring and training process.

Depreciation and Amortization. Depreciation and amortization expense consists of the depreciation of property and equipment. Depreciation and amortization expense also includes gains or losses on the disposal of fixed assets, primarily associated with remodel activities.

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

Income Tax Expense. Expense for income taxes represents amounts due for state income taxes.

Financial Performance Overview

The following table sets forth certain information regarding our financial performance for 2017, 2016 and 2015:

	Year Ended December 31,					
	2017		2016		2015	
Revenue growth	5.6	%	18.5	%	20.1	%
Same-store sales percentage change	(5.9))%	0.5	%	2.0	%
Average unit volume (in thousands)	\$4,119		\$4,531		\$4,506	
Sales per square foot	\$569		\$630		\$625	
Restaurant operating profit (in thousands)	\$19,099		\$23,688		\$23,212	
Restaurant operating profit as a percentage of sales	10.7	%	14.0	%	16.2	%
EBITDA (in thousands)	\$(6,375)		\$(6,571)		\$5,693	
EBITDA as a percentage of sales	(3.6))%	(3.9))%	4.0	%
Adjusted EBITDA (in thousands)	\$4,830		\$5,883		\$5,854	
Adjusted EBITDA as a percentage of sales	2.7	%	3.5	%	4.1	%

The table below sets forth our reconciliation of Net Loss to EBITDA, Adjusted EBITDA and restaurant operating profit to the most comparable U.S. GAAP measure.

	Year Ended December 31,		
	2017	2016	2015
	(In thousands)		
Net loss	\$(23,432)	\$(21,629)	\$(4,496)
Income tax expense	90	66	43
Interest expense, net	1,784	571	180
Depreciation and amortization	15,183	14,421	9,966
EBITDA	\$(6,375)	\$(6,571)	\$5,693
Asset impairment charge	9,341	12,454	—
Lease termination and exit costs	1,392	—	—
Other	—	—	161
Write-off of deferred financing costs	472	—	—
Adjusted EBITDA	4,830	5,883	5,854
General and administrative	13,453	13,272	12,612
Preopening expense	816	4,533	4,746
Restaurant operating profit	\$19,099	\$23,688	\$23,212

Percent of Revenue
Year Ended December
31,

Edgar Filing: KONA GRILL INC - Form 10-K

	2017	2016	2015
Net loss	(13.1)%	(12.8)%	(3.1)%
Income tax expense	0.1	0.0	0.0
Interest expense, net	1.0	0.3	0.1
Depreciation and amortization	8.5	8.5	7.0
EBITDA	(3.6)	(3.9)	4.0
Asset impairment charge	5.2	7.3	—
Lease termination and exit costs	0.8	—	—
Other	—	—	0.1
Write-off of deferred financing costs	0.3	—	—
Adjusted EBITDA	2.7	3.5	4.1
General and administrative	7.5	7.8	8.8
Preopening expense	0.5	2.7	3.3
Restaurant operating profit	10.7 %	14.0 %	16.2%

Certain percentage amounts may not sum to total due to rounding.

Store Growth Activity

	2017	2016	2015
Number of Restaurants at Beginning of Year	45	37	30
Openings	1	8	7
Total	46	45	37

Results of Operations

The following table sets forth, for the years indicated, our Consolidated Statements of Comprehensive Loss expressed as a percentage revenue.

	Year Ended December 31,		
	2017	2016	2015
Revenue	100.0%	100.0%	100.0%
Costs and expenses:			
Cost of sales	27.2	26.7	27.1
Labor	36.7	36.6	35.1
Occupancy	9.3	8.1	7.4
Restaurant operating expenses	16.2	14.6	14.2
General and administrative	7.5	7.8	8.8
Preopening expense	0.5	2.7	3.3
Depreciation and amortization	8.5	8.5	7.0
Asset impairment charge	5.2	7.3	—
Lease termination and exit costs	0.8	—	—
Other	—	—	0.1
Total costs and expenses	111.8	112.4	103.0
Loss from operations	(11.8)	(12.4)	(3.0)
Write off of deferred financing costs	0.3	—	—
Interest expense, net	1.0	0.3	0.1
Loss before income taxes	(13.0)	(12.7)	(3.1)
Income tax expense	0.1	—	—
Net loss	(13.1)%	(12.8)%	(3.1)%

Certain percentage amounts may not sum to the total due to rounding.

Year Ended December 31, 2017 Compared with Year Ended December 31, 2016

Revenue. Revenue increased 5.6% to \$179.1 million for 2017 from \$169.5 million in the prior year period, primarily due to a 14.6% increase in the number of operating weeks from nine restaurants opened since April 2016. Same store sales decreased 5.9% in 2017 compared to an increase of 0.5% in 2016 driven primarily by a decline in customer traffic compared to the prior year period.

Cost of Sales. Cost of sales increased \$3.4 million, or 7.4% to \$48.7 million in 2017 compared to \$45.3 million in 2016. As a percentage of revenue, cost of sales was 27.2% compared to 26.7% during prior year, primarily reflecting unfavorable commodity pricing on certain seafood, meat and produce items and an increase in beer costs as a result of promotions offered at certain locations in an effort to increase customer traffic.

Labor. Labor costs for 2017 increased \$3.8 million, or 6.0% to \$65.8 million compared to \$62.0 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 revenue increased slightly to 36.7% compared to 36.6% in the prior year period driven mainly by increased wage costs due to certain state mandated minimum wage increases.

Occupancy. Occupancy expenses increased \$2.8 million or 20.7% to \$16.6 million for 2017 compared to \$13.8 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 revenue were 9.3% in 2017 compared to 8.1% for 2016.

Restaurant Operating Expenses. Restaurant operating expenses increased \$4.2 million, or 16.9%, to \$28.9 million during 2017 compared to \$24.7 million in 2016, primarily due to incremental operating expenses associated with nine new locations opened since April 2016. Restaurant operating expenses as a percentage of revenue were 16.2% for 2017 compared to 14.6% for 2016. The year over year increase was driven primarily by higher advertising costs associated with increased marketing efforts to enhance brand awareness, increased repair and maintenance activity, and higher delivery and service related fees.

General and Administrative. General and administrative increased slightly to \$13.4 million during 2017 compared to \$13.3 million in the prior year period. General and administrative expenses as a percentage of sales decreased to 7.5% in 2017 compared to 7.8% 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, partially offset by higher professional fees associated with our increased marketing efforts contributed to the slight increase year over year in absolute dollars.

Preopening Expense. Preopening expenses were \$0.8 million and \$4.5 million for 2017 and 2016, respectively. Preopening expenses in 2017 were primarily attributable to the Scottsdale Quarter restaurant, which opened in June 2017. Preopening expenses in 2016 were primarily attributable to eight restaurants opened during 2016.

Depreciation and Amortization. Depreciation and amortization expense increased \$0.8 million or 5.3% to \$15.2 million year over year, primarily attributable to the nine new restaurants opened since April 2016 partially offset by the impact of certain assets that became fully depreciated in 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 revenue was 8.5% for 2017 and 2016, respectively.

Asset Impairment Charge. During 2017 and 2016, we recorded non-cash asset impairment charges of \$9.3 million and \$12.5 million, respectively, 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.

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 2017.

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 year ended December 31, 2017.

Interest Expense, Net. Interest expense increased year over year due to borrowings under the credit facility, with \$37.8 million and \$26.8 million outstanding under the credit facility as of the end of the fourth quarter 2017 and 2016, respectively. We used the borrowings to fund restaurant construction activities and stock repurchases during 2017 and 2016.

Income Tax Expense. Income tax expense was \$90,000 and \$66,000 during 2017 and 2016, respectively, related to state income tax expenses for which no state net operating loss carryforwards or other credits exist.

Year Ended December 31, 2016 Compared with Year Ended December 31, 2015

Revenue. Revenue increased 18.5% to \$169.5 million during 2016 from \$143.0 million in 2015, primarily due to a 24% increase in the number of operating weeks and same-store sales growth of 0.5% year over year. The increase is primarily due to revenue generated by eight restaurants opened during 2016 and a full year of sales for seven restaurants that opened during 2015.

Cost of Sales. Cost of sales increased \$6.5 million, or 16.8% to \$45.3 million in 2016 compared to \$38.8 million in 2015, with the increase primarily attributable to our new locations opened since the beginning of the fourth quarter of 2015. As a percentage of revenue, cost of sales was 26.7% compared to 27.1% in the prior year, primarily reflecting improved kitchen efficiencies and favorable commodity pricing for poultry, produce and dairy products compared to 2015.

Labor. Labor expense for our restaurants increased to \$62.0 million from \$50.2 million in 2015, an increase of 23.6%, primarily due to the twelve new restaurants opened since the beginning of the fourth quarter of 2015. Labor expenses as a percentage of revenue increased to 36.6% compared to 35.1% in the prior year, reflecting labor inefficiencies from our newly opened locations, increased wage costs due to certain state or local mandated minimum wage increases and a competitive labor market, and higher benefit 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 \$3.2 million or 30.6% to \$13.8 million year over year, primarily associated with base rent and common area maintenance charges for twelve new locations opened since the beginning of the fourth quarter of 2015. Occupancy expenses as a percentage of revenue were 8.1% in 2016 compared to 7.4% in 2015.

Restaurant Operating Expenses. Restaurant operating expenses increased \$4.4 million, or 21.9%, to \$24.7 million in 2016, primarily due to the additional operating expenses for twelve new restaurants opened since the beginning of the fourth quarter of 2015. Restaurant operating expenses as a percentage of revenue were 14.6% and 14.2% in 2016 and 2015, respectively. The year over year increase was driven in part by higher repair and maintenance costs, marketing expenses, professional services and training-related travel costs.

General and Administrative. General and administrative expenses increased in absolute dollars by \$0.7 million, or 5.2% to \$13.3 million from \$12.6 million year over year; however, these expenses decreased as a percentage of sales to 7.8% in 2016 compared to 8.8% in the prior year. Increased payroll, benefit costs and recruiting fees associated with additional headcount to support our unit growth expansion, higher audit fees and increased legal and professional fees contributed to the year over year increase in absolute dollars, partially offset by lower incentive compensation.

Preopening Expense. Preopening expense was \$4.5 million in 2016 compared to \$4.7 million in 2015, including non-cash rent of \$1.1 million and \$1.2 million, respectively. Preopening expense in 2016 primarily related to eight restaurants opened during the year. Preopening expense in 2015 related to seven restaurant openings and preparations for openings in the first half of 2016.

Depreciation and Amortization. Depreciation and amortization expense increased \$4.4 million or 44.7% to \$14.4 million year over year, primarily attributable to the incremental depreciation expense for eight restaurants opened during 2016 and a full year of depreciation expense for seven restaurants that opened during 2015 as well as depreciation expense associated with two restaurant remodels. Depreciation and amortization expense as a percentage of revenue was 8.5% and 7.0% of revenue in 2016 and 2015, respectively.

Asset Impairment Charge. During 2016, we recorded a non-cash asset impairment charge of \$12.5 million related to the write-down of certain long-lived assets associated with five underperforming restaurants. The asset impairment charges were based upon an assessment of each restaurant's historical operating performance combined with expected cash flows for that restaurants over the respective remaining lease term.

Other Expenses. Other expenses of \$0.2 million in 2015 primarily related to an expected settlement of a state use tax audit.

Interest Expense, Net. Interest expense increased to \$0.6 million year-over-year due to borrowings under the credit facility. We used the majority of the borrowings to fund new restaurant construction and remodel activities in 2016. We did not borrow from the credit facility during 2015.

Income Tax Expense. We recorded income tax expense of \$66,000 and \$43,000 for 2016 and 2015, respectively. Income tax expense for 2016 and 2015 relate to state income tax expense for which no net operating loss carryforwards or other credits exist partially offset by refunds primarily associated with previous year state income tax. We did not recognize any federal income tax benefit in 2016 or 2015 due to projected net operating loss carryforwards expected to be generated from tax planning strategies and available credits to offset taxable income.

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:

profitability of our restaurants, especially in new markets;

increases and decreases in comparable restaurant sales;

labor availability and wages and benefits for hourly and management personnel;

timing of new restaurant openings and related expenses;

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;

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

During our high growth phase, we required significant capital resources to construct and equip each restaurant. As we are significantly slowing the pace of growth of new restaurant development in 2018, capital resources are required to maintain our existing base of restaurants and to further strengthen the capabilities of our corporate and information technology infrastructures. 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.

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

	December 31,	
	2017	2016
Cash and short-term investments	\$5,100	\$3,654
Net working capital (deficit)	(7,559)	(10,545)

	Year Ended	
	December 31,	
	2017	2016
Cash provided by operating activities	\$5,900	\$20,887
Capital expenditures	11,840	41,900

Future Capital Requirements

Our capital requirements, including development costs related to the opening of new restaurants, have historically been significant. Over the past two years, we funded development of new restaurants and maintenance capital expenditure primarily from borrowings under our credit facility and cash flows from operations. 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 and availability under our credit line.

We opened one restaurant at the Scottsdale Quarter in 2017 compared to eight restaurants in 2016 and seven restaurants in 2015. Our current plans are for modest new restaurant growth over the next few years. We are focused on building sales, improving margins and generating cash flow to repay debt. We spent \$11.8 million on capital expenditures during the year ended December 31, 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 \$4.1 million in tenant improvement allowances during the year. Net capital expenditures was \$7.7 million for the year ended December 31, 2017. We expect to spend significantly less in capital expenditures in 2018, as we have slowed down our growth of new units. Our current plans for unit growth are through the franchising of our brand outside the United States which require significantly less capital investment.

As of December 31, 2017, we had a working capital deficit of \$7.6 million and outstanding borrowings under our credit facility of \$37.8 million. We believe existing cash and cash equivalents and short-term investments of \$5.1 million, cash flow from operations, and the ability to draw additional borrowings under our credit facility, subject to compliance with certain covenants and to the extent such borrowings are permitted under our debt arrangements, will be sufficient to fund working capital requirements over the next 12 months.

During the first quarter 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 us to take appropriate measures to generate cash. Our failure to raise capital when needed could impact our financial condition and results of operations and ability to continue as a going concern. 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 and remain a going concern.

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. The credit facility is secured by our personal property and assets. Certain of our wholly owned subsidiaries have also guaranteed the credit facility. On March 29, 2017, we entered into Amendment No. 1 to the Second Amended and Restated Credit Agreement, which amended certain financial covenants in the Second Amended Credit Agreement.

On July 7, 2017, we entered into Amendment No. 2 to the Second Amended and Restated Credit Agreement (“Amendment No.2”). Amendment No. 2 amended 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, resulted in an overall reduction of the credit facility from \$60 million to \$45 million. Additionally, (a) the maturity date was amended from 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) the applicable margins for base rate loans and the applicable margins for LIBOR rate loans were increased by 25 bps to 75 bps depending on the Company’s leverage ratio; and (c) the maximum leverage ratio was increased and the minimum fixed charge coverage ratio was decreased to provide increased flexibility as further described below. The terms of Amendment No. 2 were effective as of June 30, 2017.

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.

On October 30, 2017, we entered into Amendment No. 3 to the Second Amended and Restated Credit Agreement (“Amendment No. 3”). Amendment No. 3 amends the Second Amended Credit Agreement to, among other things, (a) implement a monthly reporting requirement; (b) restrict certain restricted payments as defined in the Second Amended Credit Agreement; and (c) implement a limitation on capital expenditures subject to approval by the Lenders in their sole discretion.

On March 9, 2018, we entered into Amendment No. 4 to the Second Amended and Restated Credit Agreement (“Amendment No. 4”). Amendment No. 4 amends the Second Amended Credit Agreement to, among other things, reduces the available credit on the Revolver from \$30 million to \$25 million as of the effective date of Amendment No. 4 and further reduces the available credit on the Revolver to \$22.5 million at June 30, 2018 and \$20 million at December 31, 2018. Additionally, (a) the maturity date was amended from October 12, 2019 to January 13, 2020 with no option to extend the maturity; (b) the applicable margins for base rate loans and the applicable margins for LIBOR rate loans were increased by 50 bps to 100 bps depending on the Company’s leverage ratio; and (c) the maximum leverage ratio was increased and the minimum fixed charge coverage ratio was decreased to provide increased flexibility as further described below. The terms of Amendment No. 4 were effective as of March 9, 2018.

Amendment No. 4 requires us to comply with certain covenants on a quarterly basis, including (a) a minimum fixed charge coverage ratio of (i) 1.10 to 1.00 for the fiscal quarters ended March 31, 2018, June 30, 2018 and September 30, 2018; (ii) 1.15 to 1.00 for the fiscal quarters ended December 31, 2018 and March 31, 2019 and (iii) 1.20 to 1.00 for the fiscal quarter ended June 30, 2019 and each fiscal quarter thereafter; and (b) a maximum leverage ratio of (i) 6.25 to 1.00 for the fiscal quarter ended March 31, 2018; (ii) 6.00 to 1.00 for the fiscal quarter ended June 30, 2018; (iii) 5.50 to 1.00 for the fiscal quarter ended September 30, 2018; (iv) 5.00 to 1.00 for the fiscal quarters ended December 31, 2018, March 31, 2019 and June 30, 2019; and (v) 4.25 for the fiscal quarter ended September 30, 2019 and each fiscal quarter thereafter.

The Company was not in compliance with the fixed charge coverage ratio and the leverage ratio at December 31, 2017. A waiver was received on March 9, 2018 for the quarter ended December 31, 2017. The Company believes that it is probable that it will be in compliance at future covenant compliance dates.

At December 31, 2017, we had \$37.8 million in outstanding borrowings, consisting of \$23.7 million under the Revolver and \$14.1 million under the Term Loan. As of December 31, 2017, net availability under the credit facility was \$6.25 million, subject to compliance with certain covenants.

Cash Flows

The following table summarizes our primary sources and uses of cash during the past three years:

	2017	2016	2015
	(In thousands)		
Net cash provided by (used in):			
Operating activities	\$5,900	\$20,887	\$10,294
Investing activities	(11,715)	(42,033)	(38,215)

Edgar Filing: KONA GRILL INC - Form 10-K

Financing activities	7,381	15,567	398
Net increase (decrease) in cash and cash equivalents	\$1,566	\$(5,579)	\$(27,523)

Operating Activities. We generated \$5.9 million, \$20.9 million and \$10.3 million of operating cash flows in 2017, 2016 and 2015, respectively. The year over year change in cash from operating activities is primarily due to lower net income, the amount and timing of receipt of tenant allowance reimbursements and timing of payments for accrued expenses and accounts payable.

Investing activities. Capital expenditures for 2017 were \$11.8 million, primarily associated with our Scottsdale Quarter restaurant, which opened in June 2017, residual payments from restaurants opened during the fourth quarter of 2016, the relocation of our corporate office, and maintenance capital expenditures. Capital expenditures for 2016 were \$41.9 million, primarily attributed to costs associated with eight new restaurant openings, costs for our Boca Park restaurant remodel, and residual payments from restaurants opened during the fourth quarter of 2015. Capital expenditures in 2015 were \$38.1 million, primarily associated with seven new restaurant openings and our Denver restaurant remodel.

Financing Activities. Net cash provided by financing activities for 2017 was \$7.4 million and consisted primarily of \$11.0 million in net borrowings under the credit facility and \$0.3 million of proceeds from stock option exercises and employee stock purchases, partially offset by \$3.6 million for the repurchase of common stock under the October 2016 stock repurchase program and \$0.3 million for debt issuance costs associated with amendments to our credit facility. Net cash provided by financing activities for 2016 consisted of \$26.8 million in net borrowings under the credit facility and \$0.7 million in proceeds from stock option exercises and employee stock purchases, partially offset by \$11.2 million in cash outflow associated with stock repurchase programs, \$0.5 million in fees paid for the amended credit facility and \$0.2 million in payment for withholding tax from net settled option exercise. Net cash provided by financing activities during 2015 consisted of \$0.6 million of proceeds from stock option exercises partially offsetting a \$0.2 million purchase and retirement of our common stock under the November 2015 authorization.

Off-Balance Sheet Arrangements

As of December 31, 2017, we had no off-balance sheet arrangements or obligations, other than operating leases, which are not classified as debt..

Critical Accounting Policies

Critical accounting policies are those that we believe are most important to the portrayal of our financial condition and results of operations and also require our most difficult, subjective or complex judgments. Judgments or uncertainties regarding the application of these policies may result in materially different amounts being reported under various conditions or using different assumptions. We consider the following policies to be the most critical in understanding the judgment that is involved in preparing our consolidated financial statements.

Property and Equipment

We record property and equipment at cost less accumulated depreciation, and we select useful lives that reflect the estimated economic lives of the underlying assets. We amortize leasehold improvements over the shorter of the useful life of the asset or the related lease term. We calculate depreciation using the straight-line method for financial statement purposes. We capitalize improvements and expense repairs and maintenance costs as incurred. We are often required to exercise judgment in our decision whether to capitalize an asset or expense an expenditure that is for maintenance and repairs. The useful life of property and equipment and the determination as to what constitutes a capitalized cost versus a repair and maintenance expense involves judgment by management, which may produce different amounts of repair and maintenance or depreciation expense if different assumptions were used.

We evaluate property and equipment for impairment whenever events or changes in restaurant operating results indicate that the carrying value of those assets may not be recoverable. Factors considered include, but are not limited to, significant underperformance relative to expected historical or projected future operating results; significant negative industry or economic trends; and significant changes in laws and regulations, legal factors or in the business climate. The assessment of impairment is performed on a restaurant-by-restaurant basis. Recoverability is assessed by comparing the carrying value of the asset to the undiscounted cash flows expected to be generated by the asset. This assessment process requires the use of estimates and assumptions regarding future cash flows and estimated useful lives, which are subject to a significant degree of judgment. If indicators of impairment are present and if we determine that the carrying value of the asset exceeds the fair value of the restaurant assets, an impairment charge is recorded to reduce the carrying value of the asset to its fair value. Calculation of fair value requires significant estimates and judgments which could vary significantly based on our assumptions.

We recorded long-lived asset impairment charges of \$9.3 million and \$12.5 million, for the years ended December 31, 2017 and 2016, respectively. Such amounts are included in "Asset impairment charge" in the Consolidated Statements of Comprehensive Loss. See Note 2 in the Notes to the Consolidated Financial Statements for further details on the impairment charges. We continue to monitor the operating performance of each individual restaurant. We may be required to record impairment charges in the future if certain restaurants perform below expectations.

Leasing Activities

We lease all of our restaurant properties. At the inception of the lease, we evaluate each property and classify the lease as an operating or capital lease in accordance with applicable accounting standards. We exercise significant judgment in determining the estimated fair value of the restaurant as well as the discount rate used to discount the future minimum lease payments. The term used for this evaluation includes renewal option periods only in instances in which the exercise of the renewal option can reasonably be assured and failure to exercise such option would result in an economic penalty. All of our restaurant leases are classified as operating leases.

Our lease term used for straight-line rent expense is calculated from the date we take possession of the leased premises through the lease termination date. There is potential for variability in our "rent holiday" period which typically begins on the possession date and ends on the store open date. Factors that may affect the length of the rent holiday period generally include construction related delays or situations where we take possession of the leased premises upon execution of the lease. Extension of the rent holiday period due to delays in restaurant opening will result in greater rent expensed during the rent holiday period.

We record contingent rent expense based on a percentage of revenue amounts that exceed a specified sales threshold over the periods the liability is incurred. Contingent rent expense is recorded prior to achievement of specified sales levels if achievement of such amounts is considered probable and estimable.

Leasehold improvements financed by the landlord through tenant improvement allowances are capitalized as leasehold improvements with the tenant improvement allowances recorded as deferred lease incentives. Deferred lease incentives are amortized on a straight-line basis over the lesser of the life of the asset or the lease term, including option periods which in the judgment of management are reasonably assured of renewal (same term that is used for related leasehold improvements) and are recorded as a reduction of occupancy expense. As part of the initial lease terms, we negotiate with our landlords to secure these tenant improvement allowances. There is no guarantee that we will receive tenant improvement allowances for any of our future locations, which would result in additional occupancy expenses.

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 a finance or an operating lease. Initial costs directly attributable to negotiating and arranging the lease will be included in the ROU asset. Lessees can make an accounting policy election by class of underlying asset not to recognize a ROU asset and corresponding lease liability for leases with a term of 12 months or less. All of our restaurant leases are accounted for as operating leases, with no related assets and liabilities on our balance sheet. 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 statements.

Income Taxes

We provide for income taxes based on our estimate of federal and state tax liabilities. These estimates consider, among other items, effective rates for state and local income taxes, allowable tax credits for items such as taxes paid on reported tip income, estimates related to depreciation and amortization expense allowable for tax purposes, and the tax deductibility of certain other items. Our estimates are based on information available to us at the time we prepare the income tax provision. Income tax returns are subject to audit by federal, state, and local governments, generally years after the returns are filed. These returns could be subject to material adjustments or differing interpretations of the tax laws.

Deferred income tax assets and liabilities are recognized for the expected future income tax consequences of carryforwards and temporary differences between the book and tax basis of assets and liabilities. Deferred tax assets and liabilities are measured using the income tax rate in effect during the year in which the differences are expected to reverse. The realization of tax benefits of deductible temporary differences and operating loss or tax credit carryforwards will depend on whether we have sufficient taxable income within the carryback and carryforward periods permitted by tax law to allow for utilization of the deductible amounts and carryforwards. We record net deferred tax assets to the extent we believe these assets will more likely than not be realized. In making this determination, we consider all available positive and negative evidence, including scheduled reversals of deferred tax liabilities, projected future taxable income, tax planning strategies and recent financial operations. In the event we determine that we would be able to realize our deferred income tax assets in the future in excess of their net recorded amount, we will make an adjustment to the valuation allowance which would likely result in an income tax benefit.

The Tax Cuts and Jobs Act (“the Tax Act”) was enacted on December 22, 2017. As of December 31, 2017, we have not finalized our accounting for the tax effects of the enactment of the Tax Act; however, as described in Note 5 in the Notes to the Consolidated Financial Statements, we have made a reasonable estimate of the effects on our existing deferred tax balances and uncertain tax positions. We anticipate that the completion of our 2017 income tax returns, future guidance and additional information and interpretations with the respect to the Tax Act will cause us to further review a need for provisional amounts to be recorded as of December 31, 2017. If necessary, and in accordance with SAB 118, we will record such adjustments in the period that relevant guidance and/or additional information becomes available and our analysis is completed.

Stock-Based Compensation

We apply the Black-Scholes valuation model in determining the fair value of stock option awards, which requires the use of a number of highly complex and subjective variables. These variables include, but are not limited to the actual and projected employee and director stock option exercise behavior, expected volatility, risk-free interest rate, expected dividends, and expected term. Expected volatility is based on the historical volatility of our stock. We utilize historical data to estimate option exercise and employee termination behavior within the valuation model. The

risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant for the expected term of the option. We also estimate forfeitures at the time of grant and revise these estimates, if necessary, in subsequent periods if actual forfeitures differ from those estimates. We estimate forfeitures based on our expectation of future experience while considering our historical experience. Changes in the subjective assumptions can materially affect the estimate of fair value of stock-based compensation and consequently, the related amount recognized in the Consolidated Statements of Comprehensive Loss. We are also required to establish deferred tax assets for expense relating to options that would be expected to generate a tax deduction under their original terms. The recoverability of such assets are dependent upon the actual deduction that may be available at exercise and can further be impaired by either the expiration of the option or an overall valuation allowance on deferred tax assets.

We believe the estimates and assumptions related to these critical accounting policies are appropriate under the circumstances; however, should future events result in unanticipated consequences, there could be a material impact on our future financial condition or results of operations.

Recent Accounting Pronouncements

See Note 1 Recently Issued Accounting Standards to our Consolidated Financial Statements. As described therein, in May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, *Revenue from Contracts with Customers (Topic 606)*. We adopted 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 adopted the standard retrospectively with the cumulative effect of initially applying the amended guidance recognized at January 1, 2018. Consequently, we will apply the guidance to the most current period presented in the financial statements issued subsequent to the adoption date. However, had we adopted the standard as of January 1, 2017, our revenue and operating income for 2017 would have been reduced by \$0.3 million.

Item 7A. *Quantitative and Qualitative Disclosures About Market Risk*

The following discussion of market risks contains forward-looking statements. Actual results may differ materially from the following discussion based on general conditions in the commodity and capital markets.

Primary Market Risk Exposures

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.

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

Item 8. *Financial Statements and Supplementary Data*

Reference is made to the consolidated financial statements, the notes thereto, and the report thereon, commencing on page F-1 of this report, which financial statements, notes, and report are incorporated herein by reference.

Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

Not applicable.

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) are our controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act 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. We have evaluated the eff