

KONA GRILL INC
Form 10-Q
August 09, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2018

or

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

For the transition period from _____ to _____

Commission File Number 001-34082

Kona Grill, Inc.
(Exact Name of Registrant as Specified in Its Charter)

Delaware

20-0216690

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

15059 North Scottsdale Road, Suite 300

Scottsdale, Arizona 85254

(480) 922-8100

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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.

Large accelerated filer

Accelerated filer

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

Emerging growth company

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of July 31, 2018, there were 13,258,578 shares of the registrant’s common stock outstanding.



KONA GRILL, INC.

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PART I – FINANCIAL INFORMATION**Item 1. Financial Statements****KONA GRILL, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except share data)

	June 30, 2018 (Unaudited)	December 31, 2017 (Note 1)
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 5,335	\$ 5,042
Short-term investments	58	58
Receivables	641	1,371
Inventory	1,780	1,706
Prepaid expenses and other current assets	762	867
Total current assets	8,576	9,044
Other assets	1,144	1,116
Property and equipment, net	75,305	81,639
Total assets	\$ 85,025	\$ 91,799
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 2,009	\$ 2,890
Accrued expenses	9,964	12,934
Current portion of long-term debt, net	928	779
Total current liabilities	12,901	16,603
Long-term debt, net	32,604	36,921
Deferred rent and other long-term liabilities	31,670	32,612
Total liabilities	77,175	86,136

Commitments and contingencies (Note 10)

Stockholders' equity:

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Preferred stock, \$0.01 par value, 2,000,000 shares authorized, none issued	—	—
Common stock, \$0.01 par value, 30,000,000 shares authorized, 13,374,778 shares issued and 13,258,578 shares outstanding at June 30, 2018; 10,225,915 shares issued and 10,109,715 shares outstanding at December 31, 2017	134	102
Additional paid-in capital	92,092	86,227
Accumulated deficit	(83,376)	(79,666)
Treasury stock, at cost, 116,200 shares at June 30, 2018 and December 31, 2017	(1,000)	(1,000)
Total stockholders' equity	7,850	5,663
Total liabilities and stockholders' equity	\$ 85,025	\$ 91,799

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended		Six Months Ended	
	June 30, 2018	2017	June 30, 2018	2017
Revenue	\$42,346	\$46,977	\$84,363	\$92,202
Costs and expenses:				
Cost of sales	10,722	12,996	21,530	25,549
Labor	14,986	17,104	30,385	33,829
Occupancy	4,200	4,201	8,428	8,281
Restaurant operating expenses	6,363	7,532	12,960	14,815
General and administrative	3,154	3,084	6,624	6,716
Preopening expenses	—	461	—	797
Depreciation and amortization	3,359	3,637	6,721	7,295
Lease termination costs and other	(75)	1,384	(75)	1,384
Total costs and expenses	42,709	50,399	86,573	98,666
Loss from operations	(363)	(3,422)	(2,210)	(6,464)
Write-off of deferred financing costs	—	472	37	472
Interest expense, net	624	408	1,228	714
Loss before income taxes	(987)	(4,302)	(3,475)	(7,650)
Income tax (expense) benefit	(13)	(25)	15	(50)
Net loss	\$(1,000)	\$(4,327)	\$(3,460)	\$(7,700)
Net loss per share:				
Basic and diluted	\$(0.08)	\$(0.43)	\$(0.31)	\$(0.76)
Weighted average shares used in computation:				
Basic and diluted	12,117	10,099	11,113	10,138

See accompanying notes to condensed consolidated financial statements.

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

	Six Months Ended June 30,	
	2018	2017
Operating activities		
Net loss	\$(3,460)	\$(7,700)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Depreciation and amortization	6,721	7,295
Stock-based compensation	357	482
Amortization of deferred financing costs	122	84
Write-off of deferred financing costs	37	472
Lease termination costs and other	(51)	1,384
Franchise termination	(246)	—
Change in operating assets and liabilities:		
Receivables	638	(633)
Inventory	(73)	227
Prepaid expenses and other current assets	137	287
Accounts payable	(880)	39
Accrued expenses	(2,636)	(2,249)
Deferred rent and other long-term liabilities	(884)	1,376
Net cash (used in) provided by operating activities	(218)	1,064
Investing activities		
Purchases of property and equipment	(735)	(8,789)
Insurance proceeds received on damaged equipment	64	—
Change in other assets	(10)	(52)
Net cash used in investing activities	(681)	(8,841)
Financing activities		
Borrowings from revolving credit facility	—	12,500
Repayments on revolving credit facility	(3,750)	(1,750)
Repayments on term loan	(375)	(375)
Fees paid for credit facility	(223)	(151)
Purchase and retirement of common stock	—	(3,572)
Proceeds from issuance of common stock, net of issuance costs	5,532	—
Proceeds from issuance of common stock under the Employee Stock Purchase Plan and exercise of stock options	8	242
Net cash provided by financing activities	1,192	6,894

Net change in cash and cash equivalents	293	(883)
Cash and cash equivalents at the beginning of the period	5,042	3,476
Cash and cash equivalents at the end of the period	\$5,335	\$2,593

Supplemental disclosure of cash flow information

Cash paid for interest, net of capitalized interest	\$1,257	\$732
Cash paid for income taxes, net of refunds	\$58	\$74

Noncash investing activities

Accounts payable and accruals related to property and equipment	\$114	\$1,918
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See accompanying notes to condensed consolidated financial statements.

KONA GRILL, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. Basis of Presentation

Kona Grill, Inc., including its wholly-owned subsidiaries, (referred to herein as the “Company” or “we,” “us,” and “our”) owns, operates and franchises upscale casual dining restaurants under the name “Kona Grill.” Our restaurants feature a diverse selection of contemporary American favorites and award-winning sushi items that are prepared fresh daily at each restaurant location. As of June 30, 2018, we owned and operated 46 restaurants in 23 states throughout the United States and Puerto Rico. We have two international franchise partners who opened Kona Grill locations in Dubai, United Arab Emirates; and Vaughan (Toronto), Canada in 2017. Our chief operating decision maker function is comprised of our Chief Executive Officer, Chief Operating Officer, and Chief Financial Officer who manage our restaurant operation base that aggregates into one reportable segment. Accordingly, we have a single operating segment and reporting unit structure.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“U.S. GAAP”) for interim financial information and with the rules and regulations of the U.S. Securities and Exchange Commission (“SEC”). Accordingly, they do not include all of the information and notes required by U.S. GAAP for complete financial statements. In our opinion, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2018 are not necessarily indicative of the results that may be expected for the year ending December 31, 2018.

The consolidated balance sheet at December 31, 2017 has been derived from the audited consolidated financial statements at that date but does not include all of the information and notes required by U.S. GAAP for complete financial statements. Accordingly, these unaudited condensed consolidated financial statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2017.

The Company has evaluated subsequent events and transactions for potential recognition or disclosure in the financial statements through the day these unaudited condensed consolidated financial statements are issued. See Note 12.

Recently Adopted Accounting Standards

Revenue Recognition

Effective January 1, 2018 we retrospectively adopted Accounting Standards Update (“ASU”) 2014-09 “Revenue from Contracts with Customers (Topic 606)” and related amendments, which requires an entity to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Additionally, new qualitative and quantitative disclosure requirements enable financial statement users to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

We have concluded there was not a material change in the timing and measurement of revenue as a result of adopting the new standard. The new standard primarily impacts the accounting for the upfront development and franchise fees received in connection with our franchise activity. We believe that the services we provide related to upfront fees we receive from franchisees such as territory or franchise fees do not contain separate and distinct performance obligations from the franchise right and thus those upfront fees will be recognized as revenue on a straight-line basis over the term of each respective franchise agreement upon store opening. The standard requires the unearned portion of fees received to be presented in our consolidated balance sheets as a contract liability.

We sell gift cards to our customers in our restaurants and through selected third parties. The gift cards sold to customers have no stated expiration dates and are subject to actual and/or potential escheatment rights. We recognize revenue from gift cards when: (i) the gift card is redeemed by the customer; or (ii) we determine the likelihood of the gift card being redeemed by the customer is remote (gift card breakage) and there is not a legal obligation to remit the unredeemed gift cards to the relevant jurisdiction. We evaluated the impact that ASU 2014-09 has on recognition of breakage income related to our unredeemed gift cards. Based upon the above review, we have determined that the adoption of ASU 2014-09 does not have a material effect on the timing and measurement of revenue recognized on our unaudited consolidated financial statements and related disclosures.

We adopted the new standard to all contracts at the date of initial application, effective January 1, 2018, retrospectively with the cumulative effect of approximately \$0.3 million as a change to accumulated deficit as a result of initially applying the amended guidance. We have applied 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 loss for the three and six months ended June 30, 2017 would not be affected as our first franchise location did not open until the third quarter of 2017. Upon adoption of the new revenue recognition standard, we reversed \$0.3 million of franchise revenue previously recorded associated with the upfront territory and franchise related fees as a cumulative adjustment to accumulated deficit. This cumulative adjustment increased our deferred revenue balance by \$0.3 million and is recorded in deferred rent and other long-term liabilities on the accompanying unaudited condensed consolidated balance sheet as of June 30, 2018.

In addition to the changes presented above, we have historically recognized sales commissions as a component of general and administrative expense as they are incurred. Under the new standard, certain sales commissions will be capitalized and amortized to general and administrative expense over the expected life of the customer relationship. We recognized less than a \$0.1 million cumulative effect adjustment to accumulated deficit with an increase to other assets as of January 1, 2018.

During the second quarter of 2018, we terminated the development and franchise agreements with our franchise partner in Mexico as a result of the franchisee ceasing to do business at the franchised restaurant. As a result, we recognized \$0.3 million of revenue associated with the remaining deferred upfront territory and franchise related fees.

Stock-Based Compensation

In May 2017, the Financial Accounting Standards Board ("FASB") issued ASU 2017-09, "Stock Compensation (Topic 718) Scope of Modification Accounting", which provides clarity, reduces diversity in practice, and reduces cost and complexity when applying the guidance in Topic 718 Compensation—Stock Compensation, regarding a change to the terms or conditions of a share-based payment award. Specifically, an entity is to account for the effects of a modification, unless all of the following are satisfied: (1) the fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the modified award is the same as the fair value (or calculated value or

intrinsic value, if such an alternative measurement method is used) of the original award immediately before the original award is modified; (2) the vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the original award is modified; and (3) the classification of the modified award as an equity instrument or as a liability instrument is the same as the classification of the original award immediately before the original award is modified. The Company adopted ASU 2017-09 in the first quarter of fiscal 2018, and this adoption did not result in any impact on the Company's consolidated financial position or results of operations.

Recently Issued Accounting Standards

Leases

In February 2016, ASC Topic 842, "Leases", was issued to increase the transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. In order to meet that objective, the new standard requires recognition of the assets and liabilities that arise from leases. Accordingly, a lessee will recognize a right-of-use (ROU) asset for its right to use the underlying asset and a lease liability for the corresponding lease obligation. Both the ROU asset and lease liability will initially be measured at the present value of the future minimum lease payments over the lease term. Subsequent measurement, including the presentation of expenses and cash flows, will depend on the classification of the lease as either finance or an operating lease. Initial costs directly attributable to negotiating and arranging the lease will be included in the ROU asset. Lessees can make an accounting policy election by class of underlying asset not to recognize a ROU asset and corresponding lease liability for leases with a term of 12 months or less. Accounting by lessors will remain largely unchanged from current U.S. GAAP. The leasing standard is applicable for us starting in 2019. We are required to apply the leasing standard for annual reporting periods (including interim periods therein) beginning after December 15, 2018. The leasing standard is required to be applied to leases in existence as of the date of adoption using a modified retrospective transition approach. The modified retrospective approach includes a number of optional practical expedients that companies may elect to apply. These practical expedients relate to the identification and classification of leases that commenced before the effective date, initial direct costs for leases that commenced before the effective date, and the ability to use hindsight in evaluating lessee options to extend or terminate a lease or to purchase the underlying asset. We plan to elect the transition package practical expedient permitted within the standard, which among other things, allows the carryforward of historical lease classifications, and we are further evaluating other optional practical expedients and policy elections. We are currently performing an assessment of the revised standard, and assessing our existing lease portfolio in order to determine the impact to our accounting systems, processes and internal control over financial reporting. To date, we have reviewed a sample of contracts that are representative of our current lease environment. We expect the adoption of this guidance to have a material impact on our consolidated financial statements; however, the effect is not currently estimable.

Income Taxes

In March 2018, the FASB issued ASU 2018-05, “Income Taxes (Topic 740) Amendments”, which adds various SEC paragraphs pursuant to the issuance of SEC Staff Accounting Bulletin No. 118. In particular, ASU 2018-05 amends Subtopic 740-10 Income Taxes, overall, to add information regarding Income Tax Accounting Implications of the Tax Cuts and Jobs Act, as well as other paragraphs and sections related to the income tax accounting implications of the Tax Cuts and Jobs Act. There is no transition date related to this guidance, and there is no impact on the Company's consolidated financial position or results of operations.

In February 2018 the FASB issued ASU 2018-02, “Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income”, that gives entities the option to reclassify to retained earnings tax effects related to items that have been stranded in accumulated other comprehensive income as a result of the Tax Cuts and Jobs Act (the Tax Act). An entity that elects to reclassify these amounts must reclassify stranded tax effects related to the Tax Act’s change in its US federal tax rate for all items accounted for in other comprehensive income. These entities can also elect to reclassify other stranded effects that relate to the Tax Act but do not directly relate to the change in the federal rate. For all entities, the guidance is effective for fiscal years beginning after December 15, 2018. Entities can choose whether to apply the amendments retrospectively to each period in which the effect of the Tax Act is recognized or to apply the amendments in the period of adoption. We are currently evaluating the impact of the standard and note that we have not finalized our accounting for the tax effects of the enactment of the Tax Act; however, as described in the Income Tax footnote below, we have made a reasonable estimate of the effects on our existing deferred tax balances and uncertain tax positions. See Note 7.

2. Fair Value Measurements

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

3. Net Loss Per Share

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

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

	Three Months Ended		Six Months Ended	
	June 30, 2018	2017	June 30, 2018	2017
	(In thousands, except per share data)			
Numerator:				
Net loss	\$(1,000)	\$(4,327)	\$(3,460)	\$(7,700)
Denominator:				
Weighted average shares — Basic	12,117	10,099	11,113	10,138
Effect of dilutive stock options	—	—	—	—