

Kona Grill, Inc.

Restaurants October 25, 2010

Company Description: Kona Grill, Inc. develops and operates upscale casual dining restaurants offering an eclectic American menu featuring steaks, chicken, pasta, sandwiches, salads, appetizers, and sushi. The décor includes large salt-water aquariums, a sushi bar, and indoor and outdoor lounges. As of October 2009, the company operated 24 restaurants in 15 states. Restaurants are located in retail centers, shopping malls, lifestyle centers, and entertainment centers.

3Q:10 earnings preview, maintaining estimates, reiterating BUY rating (KONA - \$3.69) BUY

Key Points

- Kona Grill (KONA) reports 3Q:10 results on October 26th after the close. We project a (\$0.03) loss per share on \$21.7mm revenue; our estimates are slightly above management's guidance.
- We think KONA will report a solid quarter with our channel checks suggesting business improved late in the quarter.
- We are maintaining our estimates which are above management's guidance range and above the consensus view.
- Recent events may help boost 4Q:10 and 2011 results, namely a strong restaurant opening in Baltimore, new menu items that may buoy the average check and more customers in the "Konavore" loyalty program.
- We are reiterating our BUY rating and \$4.50 price target. We think KONA is undervalued trading at 5.0x our 2011 EV/EBITDA estimate while its peers trade between 6.5x-7.5x forward EBITDA.

	3Q:09 Actual	3Q:10 Estimate	YOY Change	Consensus
Total Revenue	\$20,173	\$21,732	7.7%	\$21,320
EBITDA	\$768	\$1,226	59.7%	\$950
Net Income	(\$1,035)	(\$250)	N/A	(\$540)
Diluted EPS	(\$0.11)	(\$0.03)	\$0.09	(\$0.06)

KONA reports 3Q:10 results on October 26th after the market close. Management will host a conference call to discuss results on the 26th at 4:00 p.m. Central; (800) 967-7134, password 4855317.

We are maintaining our estimates. We project a (\$0.03) loss per share on \$21.7mm revenue. Our estimates are slightly above management's guidance of (\$0.05)-(\$0.11) on \$20.5mm-\$21.5mm revenue. Our estimates are also above the consensus view. Our channel checks suggest business improved late in 2Q:10. Traffic trends continued to improve, in our view, but we still project same-store sales declined (2.2%) due to lower average check. We think margins improved to 14.7% from 14.1% due to management's focus on improving operations. We think the company will report results significantly better than the prior year period.

Our channel checks suggest many KONA restaurants are seeing improving traffic trends. Our recent channel checks suggest traffic trends continue improving at KONA as the economy and consumer spending recover. Although we still model negative comps for the next four quarters, we think there may be upside to these estimates. We note that certain stores and regions still have weakness, but we are encouraged by the new opening in Baltimore, new menu items that we think can buoy the average check, and the company getting over 100,000 members in its "Konavore" loyalty program.

Financial Summary

Rev(mil)	2009A	2010E	2011E
Mar	\$19.5	\$21.1A	\$22.3E
Jun	\$21.5	\$22.7A	\$24.6E
Sep	\$20.2	\$21.7E	\$24.2E
Dec	\$20.0	\$21.6E	\$23.6E
FY	\$81.1	\$87.0E	\$94.6E
P/Sales	0.4x	0.4x	0.4x

EPS	2009A	2010E	2011E
Mar	(\$0.17)	(\$0.10)A	(\$0.05)E
Jun	(\$0.11)	\$0.03A	\$0.04E
Sep	(\$0.11)	(\$0.03)E	\$0.00E
Dec	(\$0.25)	(\$0.07)E	(\$0.06)E
FY	(\$0.62)	(\$0.16)E	(\$0.07)E
P/E	nm	nm	nm

Price:	\$3.69
52-Week Range:	\$5.62-\$2.32
Target:	\$4.50
Rating:	BUY

Shares Outstanding:	9.2 mil
Mkt. Capitalization:	\$34 mil
Ave. Volume:	13,600
Instit. Ownership:	31%
BV / Share:	\$1.90
Debt / Tot. Cap.:	5%
Est. LT EPS Growth:	18%

Investment Recommendation:

We are reiterating our BUY rating and \$4.50 price target. We derive our \$4.50 price target by applying a 6x EV/EBITDA multiple to our 2011 EBITDA estimate of \$6.2mm. Our valuation is a discount to KONA's publicly traded peers which trade at approximately 6.5x-7.5x forward EBITDA. Although we are disappointed by the July same-store sales results, we think business improved during the quarter and the company has opportunities to boost future results. We think the company has compiled a good management team, improved relations with shareholders, has improved its balance sheet and can fund new unit growth from cash flow. We think KONA is an attractive investment and maintain our BUY rating.

Kona Grill, Inc. Income Statement

	Fiscal Year	Mar-09	Jun-09	Sep-09	Dec-09	Fiscal Year	Mar-10	Jun-10	Sep-10	Dec-10	Fiscal Year	Mar-11	Jun-11	Sep-11	Dec-11	Fiscal Year
\$ in thousands except per share amounts	2008A	Q1 A	Q2 A	Q3 A	Q4 A	2009A	Q1 A	Q2 A	Q3 E	Q4 E	2010E	Q1 E	Q2 E	Q3 E	Q4 E	2011E
Restaurant Revenue	77,006	19,455	21,468	20,173	19,999	81,095	21,052	22,686	21,732	21,567	87,037	22,294	24,558	24,190	23,571	94,613
Cost of Sales																
Cost of Sales	21,092	5,097	5,461	5,267	5,233	21,058	5,575	6,014	5,661	5,650	22,901	5,819	6,385	6,265	6,140	24,609
Labor	26,004	6,749	7,269	7,117	7,382	28,517	7,583	7,782	7,545	7,538	30,448	7,914	8,374	8,333	8,191	32,813
Occupancy	5,261	1,520	1,536	1,655	1,746	6,457	1,781	1,769	1,782	1,855	7,187	1,917	1,923	1,984	2,027	7,851
Operating	11,596	3,030	3,242	3,296	3,588	13,156	3,456	3,418	3,542	3,526	13,942	3,511	3,757	3,749	3,760	14,778
Restaurant Operating Profit	13,053	3,059	3,960	2,838	2,050	11,907	2,657	3,703	3,201	2,998	12,559	3,132	4,118	3,858	3,453	14,562
Restaurant Operating Profit Margin	17.0%	15.7%	18.4%	14.1%	10.3%	14.7%	12.6%	16.3%	14.7%	13.9%	14.4%	14.1%	16.8%	16.0%	14.7%	15.4%
Pre-Opening Expense	2,073	500	352	480	353	1,685	8	119	325	35	487	10	65	355	295	725
General & Administrative	8,416	1,887	2,661	1,590	2,062	8,200	2,137	1,873	1,650	1,920	7,580	1,950	1,925	1,785	1,930	7,590
Depreciation & Amortization	6,730	1,741	1,812	1,820	1,941	7,314	1,399	1,395	1,430	1,600	5,824	1,640	1,675	1,740	1,780	6,835
Operating Income	(4,166)	(1,069)	(865)	(1,052)	(2,306)	(5,292)	(887)	316	(204)	(557)	(1,332)	(468)	453	(22)	(552)	(588)
Operating Margin	-5.4%	-5.5%	-4.0%	-5.2%	-11.5%	-6.5%	-4.2%	1.4%	-0.9%	-2.6%	-1.5%	-2.1%	1.8%	-0.1%	-2.3%	-0.6%
Interest Expense, net	245	16	(22)	22	14	30	(20)	(44)	(21)	(13)	(98)	(1)	8	15	15	37
Pretax Income	(3,921)	(1,053)	(887)	(1,030)	(2,292)	(5,262)	(907)	272	(225)	(570)	(1,430)	(469)	461	(7)	(537)	(551)
Income Tax	155	30	30	5	0	65	0	10	25	35	70	25	35	30	35	125
Tax Rate	-4.0%	-2.8%	-3.4%	-0.5%	0.0%	-1.2%	0.0%	3.7%	-11.1%	-6.1%	-4.9%	-5.3%	7.6%	-443.3%	-6.5%	-22.7%
Net Income, Common	(4,076)	(1,083)	(917)	(1,035)	(2,292)	(5,327)	(907)	262	(250)	(605)	(1,500)	(494)	426	(37)	(572)	(676)
Fully Diluted Common EPS	(0.62)	(0.17)	(0.11)	(0.11)	(0.25)	(0.62)	(0.10)	0.03	(0.03)	(0.07)	(0.16)	(0.05)	0.04	(0.00)	(0.06)	(0.07)
Diluted Shares Outstanding	6,543	6,512	8,278	9,141	9,144	8,645	9,155	9,265	9,200	9,250	9,218	9,350	9,500	9,520	9,600	9,493
EBITDA	2,564	672	947	768	(365)	2,022	806	1,711	1,226	1,043	4,786	1,172	2,128	1,718	1,228	6,247
Restaurants	20	21	22	23	24	24	24	24	24	25	25	25	25	26	27	27
Same-store sales	-7.2%	-9.6%	-9.5%	-9.9%	-8.1%	-9.3%	-2.5%	-0.3%	-2.2%	-1.5%	-1.6%	-2.1%	-2.0%	0.0%	0.0%	-1.0%

Analyst Certification

I **Mark Smith**, certify that the views expressed in this research report accurately reflect my personal views about the subject company and its securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation related to the specific recommendations expressed in this report.

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Feltl and Company Rating System: Feltl and Company utilizes a four tier rating system for potential total returns over the next 12 months.

Strong Buy: The stock is expected to have total return potential of at least 30%. Catalysts exist to generate higher valuations, and positions should be initiated at current levels.

Buy: The stock is expected to have total return potential of at least 15%. Near term catalysts may not exist and the common stock needs further time to develop. Investors requiring time to build positions may consider current levels attractive.

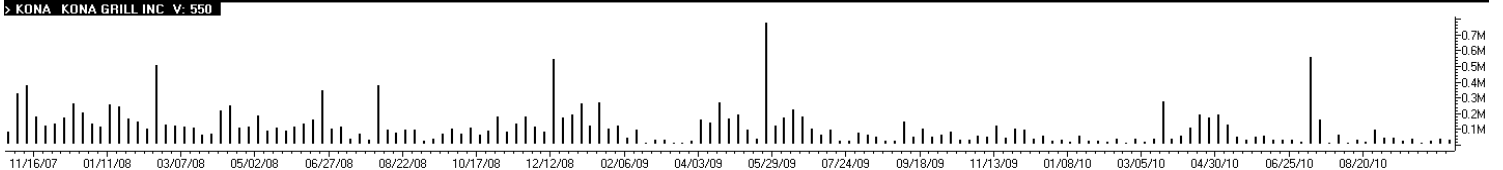
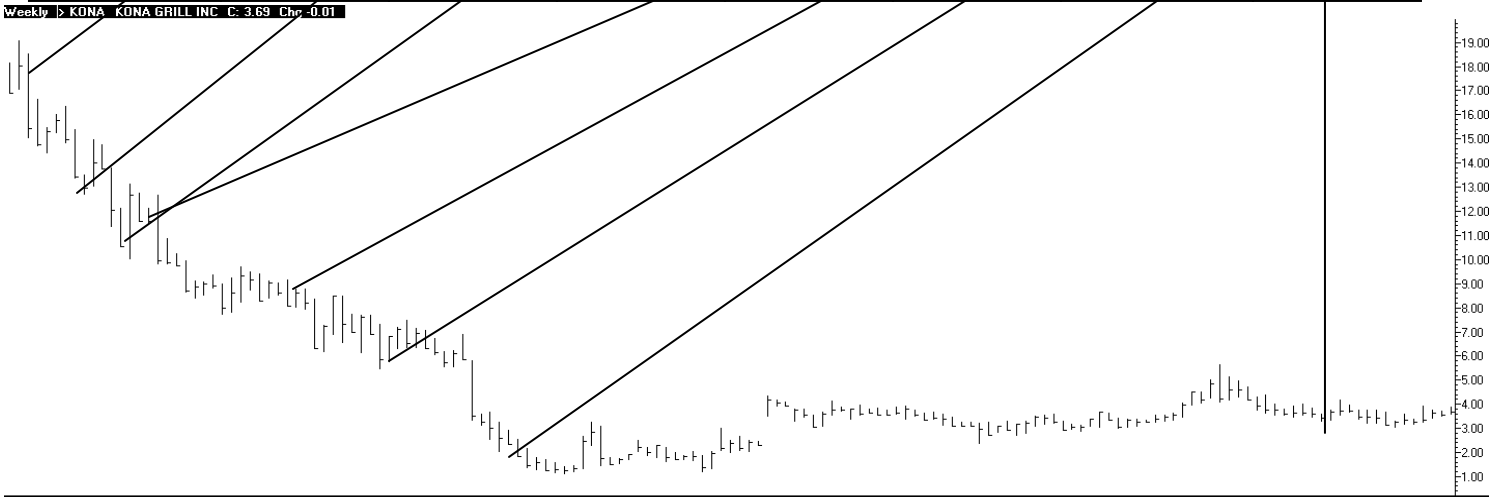
Hold: The stock is expected to have total return potential of less than 15%. Fundamental events are not present to make it either a Buy or a Sell. The stock is an acceptable longer-term holding.

Sell: Expect a negative total return. Current positions may be used as a source of funds.

Ratings Distribution for Feltl and Company				
10/25/2010				
Rating	Number of Stocks	Percent of Total	----- Investment Banking -----	
			Number of Stocks	Percent of Rating category
SB/Buy	36	75%	2	6%
Hold	12	25%	0	0%
Sell	0	0%	0	0%
	48	100%	2	4%

The above represents our ratings distribution on the stocks in the Feltl and Company research universe, together with the number in (and percentage of) each category for which Feltl and Company provided investment-banking services in the previous twelve months.

11/01/07 Hold Target: \$19	12/10/07 Buy Target: \$19	01/11/08 Buy Target: \$16	2/15/08 Hold Target: \$11	5/01/08 Hold Target: \$10	7/30/08 Hold Target: \$7	10/23/08 Hold Target: NA	7/26/10 Buy Target: \$4.50
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Date	Nature of Report	Rating	Price Target
10/03/05	Initiating Coverage	Buy	\$13
02/14/07	Update	Hold	na
05/01/07	Q1 Reported New Analyst	Hold	na
05/13/07	Upgrade Rating to Buy	Buy	\$21
11/01/07	Downgrade Rating to Hold, Lower Target	Hold	\$19
12/10/07	Upgrade Rating to BUY	Buy	\$19
01/11/08	Reduce Target	Buy	\$16
02/15/08	Downgrade Rating to Hold, Lower Target	Hold	\$11
05/01/08	Reduce Target	Hold	\$10
07/30/08	Reduce Target	Hold	\$7
10/23/08	Eliminate Price Target	Hold	NA
07/26/10	Upgrade Rating to BUY, Introduce Target	Buy	\$4.50

Feltl and Company does make a market in the subject security at the date of publication of this report. As a market maker, Feltl and Company could act as principal or agent with respect to the purchase or sale of those securities.

Valuation and Price Target Methodology:

We derive our \$4.50 price target by applying a 6x EV/EBITDA estimate to our 2011 EBITDA estimate of \$6.2mm.

Risks to Achievement of Estimates and Price Target:

- **Consumer Preferences:** Although the concept has performed well to date, if consumer preferences change for any reason, the Company may have difficulty adapting the menu and décor to meet these changes. To reduce this risk, some restaurant companies own different restaurants with different themes. Kona Grill operates on a single theme. Therefore, the risk associated with changing customer preferences is higher than average.
- **Delays:** If the construction or equipment procurement process is delayed at new restaurant units, the company's financial results could be negatively impacted. Kona Grill initiates lease payments prior to the opening of the associated restaurant unit. Also, the Company spends approximately \$2.5 million in up-front expenses on each unit, which will not generate a return until the unit is operating. This risk is higher in the near-term as more restaurants are being added. In the long-run, this risk should diminish.
- **Site Selection:** The Company relies on the site selection skills of management. Although considerable thought has been put into ideal site characteristics, the process may become more challenging over time. Eventually, the Company may determine that some of its selected sites are less-than-optimal. This could impact future revenue potential.
- **Margins:** Casual Dining Restaurants typically generate low profit margins at the unit level. Management typically attempts to leverage corporate expenses by operating a growing number of units. Therefore, any factor that reduces profit margins at the unit level may substantially reduce returns to investors in the corporation. Management has limited ability to keep competition away, or pass on price increases to its customers.
- **New financing:** We project the company may need additional financing to fund its further restaurant development efforts. There is no assurance the company can raise money at acceptable terms. Equity financing may be dilutive to current shareholders' while interest expense from debt financing may impede earnings.

Other Disclosures:

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