

Kona Grill, Inc.

Restaurants July 27, 2011

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. The company operates 25 restaurants in 16 states. Restaurants are located in retail centers, shopping malls, lifestyle centers, and entertainment centers.

2Q:11 results significantly better than expected, raising target and reiterating BUY (KONA - \$6.64) BUY

Key Points

- Kona Grill (KONA) reported significantly better-than-expected 2Q:11 results with \$0.08 EPS on revenue of \$25.8mm, compared to our estimates of \$0.05 on \$25.0mm revenue and consensus of \$0.04 on \$24.8mm. Results also exceeded guidance of \$0.02-\$0.04 EPS on \$24-\$25mm revenue.

	2Q:11 Actual	2Q:11 Estimate	Variance	2Q:10 Actual	YOY Change
Total Revenue	\$25,767	\$24,997	\$770	\$22,686	\$3,081
EBITDA	\$2,287	\$2,052	\$235	\$1,711	\$576
Net Income	\$783	\$459	\$324	\$262	\$521
Diluted EPS	\$0.08	\$0.05	\$0.03	\$0.03	\$0.06

- Same-store sales increased 9.1% compared to our 4.6% estimate and restaurants not in the comp base performed better than expected.
- Management guided for 3Q:11 results of \$23.1-\$24.1mm revenue and EPS of \$0.01-\$0.03, roughly inline with our prior estimates.
- We think the company's focus on slowing growth to concentrate on improving restaurant operations is working as evidenced by restaurant-operating margins expanding 90 bps year-over-year to 17.2%. Restaurant margins improved despite steep commodity price inflation.
- We are adjusting our 2011 and 2012 estimates and expect 2011 revenue, EBITDA and EPS of \$97.6mm, \$7.4mm and \$0.13, respectively, compared to our prior estimates of \$96.2mm, \$7.1mm and \$0.07. We raised our 2012 estimates for revenue, EBITDA and EPS to \$103.2mm, \$8.5mm and \$0.17, respectively, from \$101.8mm, \$8.1mm and \$0.10.
- With improving results, we think KONA is ready to enter a new growth phase in 2012 – management indicated they will open two new restaurants in 2012. We think growth could accelerate in 2013 and beyond.
- We are raising our price target to \$8.00 from \$6.50 and reiterating our BUY rating. We derive our \$8 price target by applying an 8x EV/EBITDA multiple to our new 2012 estimate of \$8.5mm. We think KONA has the potential to begin growing aggressively with a new management team in place, an improved financial profile and strong results at current locations.

Financial Summary

Rev(mil)	2010A	2011E	2012E
Mar	\$21.1	\$23.6A	\$24.3E
Jun	\$22.7	\$25.8A	\$26.4E
Sep	\$21.6	\$24.3E	\$25.6E
Dec	\$22.2	\$23.9E	\$26.9E
FY	\$87.6	\$97.6E	\$103.2E
P/Sales	0.7x	0.6x	0.6x

EPS	2010A	2011E	2012E
Mar	(\$0.10)	(\$0.01)A	\$0.00E
Jun	\$0.03	\$0.08A	\$0.08E
Sep	(\$0.05)	\$0.04E	\$0.05E
Dec	(\$0.05)	\$0.01E	\$0.03E
FY	(\$0.17)	\$0.07E	\$0.17E
P/E	nm	nm	nm

Price:	\$6.64
52-Week Range:	\$7.69-\$3.00
Target:	\$8.00
Rating:	BUY
Shares Outstanding:	9.2 mil
Mkt. Capitalization:	\$61 mil
Ave. Volume:	27,600
Instit. Ownership:	31%
BV / Share:	\$1.95
Debt / Tot. Cap.:	3%
Est. LT EPS Growth:	18%

KONA reported better-than-expected 2Q:11 results with strong comp growth and improving margins. Same-store sales increased 9.1% compared to our 4.6% estimate and restaurants not in the comp base helped drive revenue growth of 13.6% to \$25.8mm compared to our estimate of \$25.0mm and management's guidance of \$24-\$25mm. We think the company benefited from improved traffic and successful menu price increases. Restaurant-level margins increased 90bps year over year to 17.2% despite steep commodity price inflation. KONA reported 2Q:11 EPS of \$0.08 compared to our estimate of \$0.05 and consensus of \$0.04. We note that G&A expense had \$257k in separation expense for the prior CEO which would boost EPS to \$0.11 if excluded as a one-time item. We think the company had a strong quarter as this marks the sixth consecutive quarter of positive traffic trends and restaurant profitability improved.

3Q:11 guidance was roughly inline with our estimates. Management issued 3Q:11 guidance for \$23.1mm-\$24.1mm revenue and EPS of \$0.01-\$0.03 compared to our prior estimates of \$23.9mm and \$0.03, respectively. Management has a tendency to be conservative in its guidance and we are tweaking our estimates slightly higher. We now project revenue of \$24.3mm, slightly above the high-end of guidance, and EPS of \$0.04, slightly above the guided range.

We are raising our 2011 and 2012 estimates. We are raising our 2011 revenue, EBITDA and EPS estimates to \$97.6mm, \$7.4mm and \$0.13, respectively, from \$96.2mm, \$7.1mm and \$0.07. We think the strong sales growth will continue in 2011 and think the company can leverage its fixed costs and rising commodities. KONA does not currently have any leases for new restaurants signed, but we think management is preparing to enter a renewed growth phase in 2012 and management indicated it will open two new restaurants in 2012, inline with our model. We think management took the prudent steps of slowing new unit growth during the downturn and successfully focused on restaurant profitability, but we think efforts can now start to turn towards prudent growth. We maintained our estimates for two new restaurant openings in 2012 which help drive some sales improvement, but pre-opening expense mutes any positive impact from these openings. We are raising our 2012 revenue, EBITDA and EPS estimates to \$103.2mm, \$8.5mm and \$0.17, respectively, from \$101.8mm, \$8.1mm and \$0.10 as we think the positive momentum in 2011 will carry into 2012.

We are raising our price target to \$8.00 from \$6.50. We derive our new \$8.00 price target by applying an 8x EV/EBITDA multiple to our new 2012 EBITDA estimate of \$8.5mm. We previously valued the shares at a 7x multiple on our prior 2012 EBITDA estimate of \$8.1mm. Our 8.0x multiple is roughly inline with other growth oriented casual diners. Despite no near-term unit growth, we think there are ample opportunities for KONA to open new units in 2012 and beyond. KONA has a relatively clean balance sheet with approximately \$4.0mm in net cash and we think the cash position can grow over the next twelve months due to low capital spending in 2011.

Investment Recommendation:

We are reiterating our BUY rating. We are encouraged by the improving results at KONA as the same-store sales have sequentially improved for seven consecutive quarters, traffic has been positive for six consecutive quarters, restaurant-operating margins have improved year over year for the last three quarters and KONA will produce EPS in 2011. We think there is still more work to be done by the new management team, but we are encouraged by the improvements and think the company can start to focus on new unit growth.

Kona Grill, Inc. Income Statement

\$ in thousands except per share amounts	Fiscal Year		Mar-10	Jun-10	Sep-10	Dec-10	Fiscal Year	Mar-11	Jun-11	Sep-11	Dec-11	Fiscal Year	Mar-12	Jun-12	Sep-12	Dec-12	Fiscal Year
	2008A	2009A	Q1 A	Q2 A	Q3 A	Q4 A	2010A	Q1 A	Q2 A	Q3 E	Q4 E	2011E	Q1 E	Q2 E	Q3 E	Q4 E	2012E
Restaurant Revenue	77,006	81,095	21,052	22,686	21,605	22,246	87,589	23,632	25,767	24,265	23,929	97,594	24,255	26,367	25,634	26,924	103,180
Cost of Sales																	
Cost of Sales	21,092	21,058	5,575	6,014	5,936	6,325	23,850	6,657	7,052	6,588	6,461	26,758	6,452	6,948	6,729	7,067	27,196
Labor	26,004	28,517	7,583	7,782	7,535	7,752	30,652	8,093	8,551	8,323	8,303	33,270	8,368	8,833	8,767	9,275	35,243
Occupancy	5,261	6,457	1,781	1,769	1,777	1,772	7,099	1,791	1,872	1,868	1,890	7,422	1,914	1,951	2,051	2,132	8,048
Operating	11,596	13,156	3,456	3,418	3,582	3,723	14,179	3,789	3,856	3,773	3,829	15,247	3,784	3,908	3,922	4,227	15,840
Restaurant Operating Profit	13,053	11,907	2,657	3,703	2,775	2,674	11,809	3,302	4,436	3,713	3,446	14,896	3,738	4,728	4,165	4,222	16,852
Restaurant Operating Profit Margin	17.0%	14.7%	12.6%	16.3%	12.8%	12.0%	13.5%	14.0%	17.2%	15.3%	14.4%	15.3%	15.4%	17.9%	16.3%	15.7%	16.3%
Pre-Opening Expense	2,073	1,685	8	119	382	58	567	0	0	0	60	60	130	280	170	295	875
General & Administrative	8,416	8,200	2,137	1,873	1,446	1,616	7,072	1,882	2,149	1,695	1,705	7,431	1,940	1,945	1,755	1,845	7,485
Depreciation & Amortization	6,730	7,314	1,399	1,395	1,384	1,488	5,666	1,490	1,482	1,580	1,610	6,162	1,630	1,685	1,735	1,810	6,860
Operating Income	(4,166)	(5,292)	(887)	316	(437)	(488)	(1,496)	(70)	805	438	71	1,243	38	818	505	272	1,632
Operating Margin	-5.4%	-6.5%	-4.2%	1.4%	-2.0%	-2.2%	-1.7%	-0.3%	3.1%	1.8%	0.3%	1.3%	0.2%	3.1%	2.0%	1.0%	1.6%
Interest Expense, net	245	30	(20)	(44)	(4)	(3)	(71)	(12)	(7)	(2)	7	(14)	14	10	8	7	39
Pretax Income	(3,921)	(5,262)	(907)	272	(441)	(491)	(1,567)	(82)	798	436	78	1,229	52	828	513	279	1,671
Income Tax	155	65	0	10	0	0	10	10	15	20	10	55	15	20	25	15	75
Tax Rate	-4.0%	-1.2%	0.0%	3.7%	0.0%	0.0%	-0.6%	-12.2%	1.9%	4.6%	12.9%	4.5%	29.0%	2.4%	4.9%	5.4%	4.5%
Net Income, Common	(4,076)	(5,327)	(907)	262	(441)	(491)	(1,577)	(92)	783	416	68	1,174	37	808	488	264	1,596
Fully Diluted Common EPS	(0.62)	(0.62)	(0.10)	0.03	(0.05)	(0.05)	(0.17)	(0.01)	0.08	0.04	0.01	0.13	0.00	0.08	0.05	0.03	0.17
Diluted Shares Outstanding	6,543	8,645	9,155	9,265	9,168	9,180	9,167	9,203	9,392	9,395	9,440	9,358	9,500	9,575	9,650	9,725	9,613
EBITDA	2,564	2,022	806	1,711	947	1,000	4,464	1,420	2,287	2,018	1,681	7,405	1,668	2,503	2,240	2,082	8,492
Restaurants	20	24	24	24	24	25	25	25	25	25	25	25	25	26	26	27	27
Same-store sales	-7.2%	-9.3%	-2.5%	-0.3%	0.0%	6.4%	0.9%	7.6%	9.1%	6.4%	1.0%	6.0%	0.1%	0.0%	1.4%	6.1%	1.9%

Analyst Certification

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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.

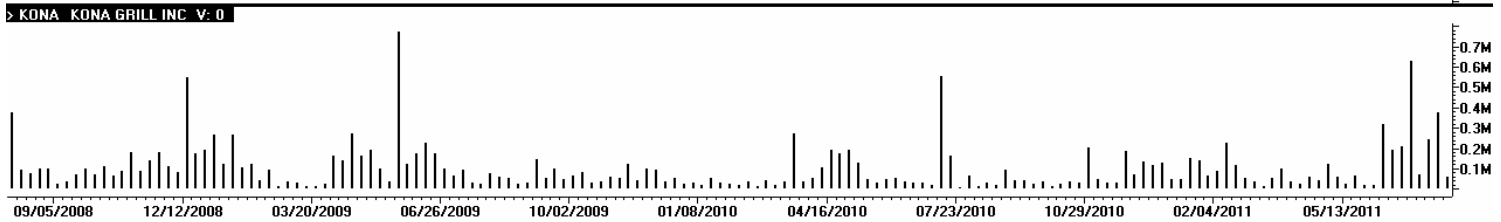
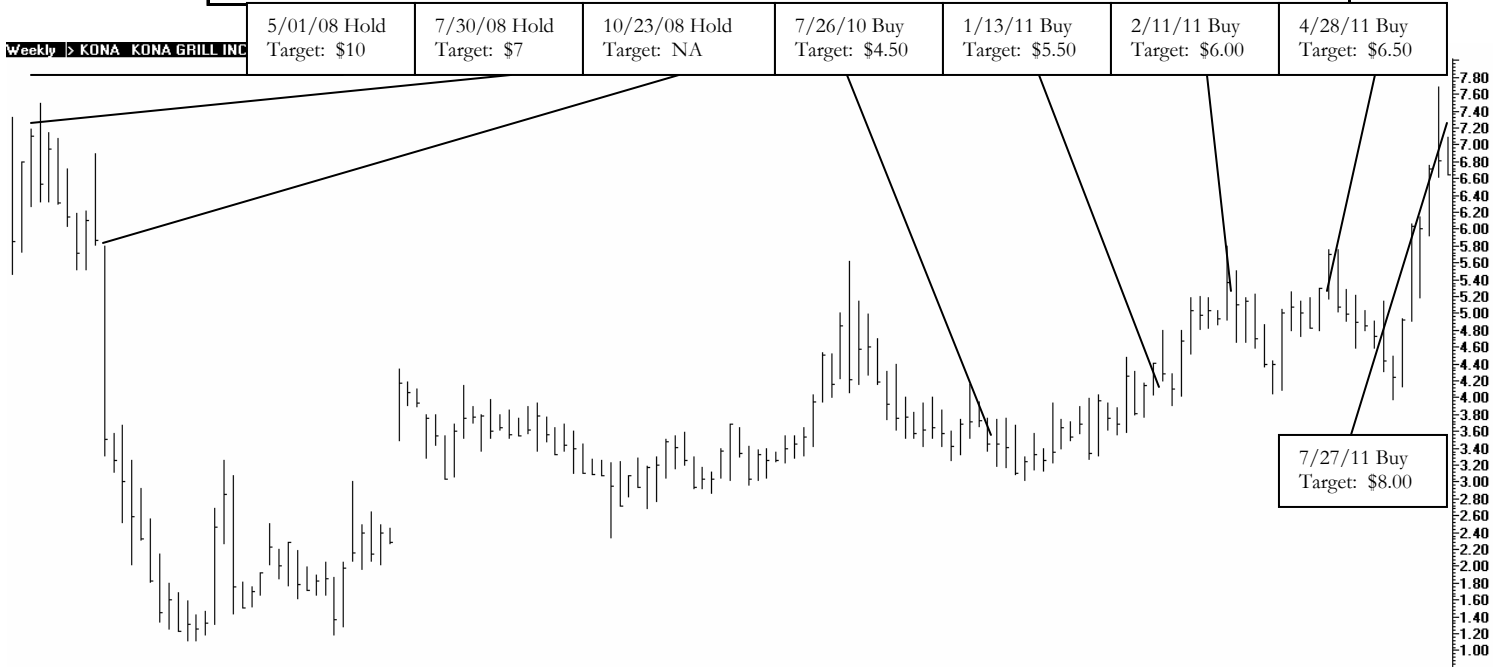
Sell: Expect a negative total return. Current positions may be used as a source of funds.

7/27/2011

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Rating	Number of Stocks	Percent of Total	----- Investment Banking -----	
			Number of Stocks	Percent of Rating category
SB/Buy	40	67%	3	8%
Hold	20	33%	0	0%
Sell	0	0%	0	0%
	60	100%	3	5%

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.



Date	Nature of Report	Rating	Price Target
10/03/05	Initiating Coverage	Buy	\$13
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

01/13/11	Raise Price Target	Buy	\$5.50
02/11/11	Raise Price Target	Buy	\$6.00
04/28/11	Raise Price Target	Buy	\$6.50
07/27/11	Raise Price Target	Buy	\$8.00

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Valuation and Price Target Methodology:

We derive our \$6.50 price target by applying a 7x EV/EBITDA estimate to our 2012 EBITDA estimate of \$8.1mm.

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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