KONA GRILL INC
Form 10-Q
August 02, 2007

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2007

or

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

Commission File Number 000-51491

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

Delaware	**20-0216690**
(State of Incorporation)	*(I.R.S. Employer Identification No.)*

7150 East Camelback Road, Suite 220
Scottsdale, Arizona 85251
(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 þ No o

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

Large accelerated filer o Accelerated filer o Non-accelerated filer þ

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

Yes o No þ

As of July 31, 2007, there were 5,887,287 shares of the registrant s common stock outstanding.

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PART I FINANCIAL INFORMATION

Item 1. Unaudited Consolidated Financial Statements

KONA GRILL, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	June 30, 2007 (Unaudited)	December 31, 2006 (Note 1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 3,209	$ 1,934
Investments	8,429	14,249
Receivables	347	949
Other current assets	1,389	741
Total current assets	13,374	17,873
Other assets	442	407
Property and equipment, net	42,653	40,516
Total assets	$ 56,469	$ 58,796
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 2,102	$ 4,616
Accrued expenses	3,674	3,502
Current portion of notes payable	637	613
Total current liabilities	6,413	8,731
Notes payable	2,375	2,700
Deferred rent	11,650	11,543
Total liabilities	20,438	22,974
Commitments and contingencies		
Stockholders equity:		
Preferred stock, $0.01 par value, 2,000,000 shares authorized, none issued at June 30, 2007 and December 31, 2006		
Common stock, $0.01 par value, 15,000,000 shares authorized, 5,871,949 and 5,847,593 shares issued and outstanding at June 30, 2007 and December 31, 2006, respectively	59	58
Additional paid-in capital	42,239	41,722
Accumulated deficit	(6,267)	(5,957)
Accumulated other comprehensive loss		(1)
Total stockholders equity	36,031	35,822

Total liabilities and stockholders equity	$	56,469	$	58,796

See accompanying notes to the unaudited consolidated financial statements.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(Unaudited)			
Restaurant sales	$ 19,322	$ 11,877	$ 34,988	$ 22,071
Costs and expenses:				
Cost of sales	5,487	3,299	10,033	6,194
Labor	5,970	3,578	11,045	6,731
Occupancy	1,205	812	2,263	1,518
Restaurant operating expenses	2,742	1,480	4,876	2,926
General and administrative	1,832	1,625	3,601	3,639
Preopening expense	350	689	838	980
Depreciation and amortization	1,477	823	2,766	1,553
Total costs and expenses	19,063	12,306	35,422	23,541
Income (loss) from operations	259	(429)	(434)	(1,470)
Nonoperating income (expense):				
Interest income	131	246	291	483
Interest expense	(42)	(75)	(42)	(154)
Income (loss) before provision for income taxes	348	(258)	(185)	(1,141)
Provision for income taxes	35	45	45	50
Net income (loss)	$ 313	$ (303)	$ (230)	$ (1,191)
Net income (loss) per share:				
Basic	$ 0.05	$ (0.05)	$ (0.04)	$ (0.21)
Diluted	$ 0.05	$ (0.05)	$ (0.04)	$ (0.21)
Weighted average shares used in computation:				
Basic	5,866	5,793	5,860	5,762
Diluted	6,233	5,793	5,860	5,762

See accompanying notes to the unaudited consolidated financial statements.

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

	Six Months Ended June 30, 2007	Six Months Ended June 30, 2006
Operating activities	(Unaudited)	
Net loss	$ (230)	$ (1,191)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	2,766	1,553
Stock-based compensation expense	341	402
Tax benefit on exercise of stock options	5	
Change in operating assets and liabilities:		
Receivables	602	(2,048)
Other current assets	(648)	(437)
Accounts payable	(901)	394
Accrued expenses	107	639
Deferred rent	107	2,528
Net cash provided by operating activities	2,149	1,840
Investing activities		
Purchase of property and equipment	(6,516)	(9,050)
(Increase) decrease in other assets	(35)	11
Net proceeds on purchase and sale of short-term investments	5,821	4,504
Net cash used in investing activities	(730)	(4,535)
Financing activities		
Repayments of notes payable	(301)	(375)
Proceeds from issuance of common stock under the Employee Stock Purchase Plan and exercise of stock options and warrants	157	35
Net cash used in financing activities	(144)	(340)
Net increase (decrease) in cash and cash equivalents	1,275	(3,035)
Cash and cash equivalents at the beginning of the period	1,934	4,466
Cash and cash equivalents at the end of the period	$ 3,209	$ 1,431
Supplemental disclosures of cash flow information		
Cash paid for interest	$ 127	$ 154
Noncash investing activities		
(Decrease) increase in accounts payable related to property and equipment additions	$ (1,613)	$ 1,552

See accompanying notes to the unaudited consolidated financial statements.

KONA GRILL, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation and Significant Accounting Policies

Kona Grill, Inc. (referred to herein as the Company or we, us, and our) owns and operates upscale casual dining restaurants under the name Kona Grill. Our restaurants feature a diverse selection of mainstream American dishes and award-winning sushi that are prepared fresh daily. We currently own and operate 16 restaurants in 10 states throughout the United States.

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles 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 month periods ended June 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007.

The consolidated balance sheet at December 31, 2006 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. Accordingly, these financial statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2006.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash, money market funds, and highly liquid short-term fixed income securities with a remaining maturity of 90 days or less when acquired. Amounts receivable from credit card processors are also considered cash equivalents because they are both short-term and highly liquid in nature and are typically converted to cash within one business day of the sales transaction. Under the Company s asset classification practices, when there is no legal right of offset against cash balances in a specific financial institution, uncleared checks are classified as accounts payable. Uncleared checks totaling approximately $860,000 and $640,000 were included in accounts payable as of June 30, 2007 and December 31, 2006, respectively.

Recent Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 is an interpretation of FASB Statement No. 109, *Accounting for Income Taxes*, and it seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. FIN 48 requires that the impact of a tax position in a company s financial statements be recognized if that position will more likely than not be sustained on audit, based on the technical merits of the position. We adopted FIN 48 effective January 1, 2007. See Note 7 for discussion of the adoption of FIN 48.

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 provides guidance for using fair value to measure assets and liabilities. The standard expands required disclosures about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. SFAS 157 is effective for fiscal years beginning after November 15, 2007. We do not believe the adoption of SFAS 157 will have a material impact on our consolidated financial statements.

KONA GRILL, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

2. Net Income (Loss) Per Share

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(In thousands, except per share data)			
Numerator:				
Net income (loss)	$ 313	$ (303)	$ (230)	$ (1,191)
Denominator:				
Weighted average shares Basic	5,866	5,793	5,860	5,762
Effect of dilutive stock options and warrants	367			
Weighted average shares Diluted	6,233	5,793	5,860	5,762
Net income (loss) per share:				
Basic	$ 0.05	$ (0.05)	$ (0.04)	$ (0.21)
Diluted	$ 0.05	$ (0.05)	$ (0.04)	$ (0.21)

For the three and six months ended June 30, 2007, there were approximately 117,000 and 918,000 stock options and warrants outstanding, respectively, that were not included in the dilutive earnings per share calculation because the effect would have been anti-dilutive. For the three and six months ended June 30, 2006, approximately 771,000 stock options and warrants outstanding were excluded from the dilutive earnings per share calculation for the same reason.

3. Investments

The following is a summary of available-for-sale securities (in thousands):

	Adjusted Cost	Gross Unrealized Losses	Estimated Fair Value
June 30, 2007			
Auction rate municipal securities	$ 8,275	$	$ 8,275
Corporate securities	154		154
	$ 8,429	$	$ 8,429
December 31, 2006			
Auction rate municipal securities	$ 10,600	$	$ 10,600
Government bonds	3,000	(1)	2,999
Corporate securities	650		650
	$ 14,250	$ (1)	$ 14,249

The original maturity date for our government bonds and corporate securities is one year or less. Although original maturities of our auction rate municipal securities are generally longer than one year, we have the right to sell these securities each auction date subject to the availability of buyers. The original maturity dates for these investments ranged from 2029 to 2047 at June 30, 2007.

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KONA GRILL, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

4. Accrued Expenses

Accrued expenses consisted of the following (in thousands):

	June 30, 2007	December 31, 2006
Accrued payroll	$ 1,283	$ 1,471
Sales taxes	564	485
Business and income taxes	459	297
Gift cards	350	372
Accrued occupancy	244	166
Other	774	711
	$ 3,674	$ 3,502

5. Stock-Based Compensation

We maintain stock award plans which provide for discretionary grants of incentive and nonstatutory stock options, restricted stock, and other types of awards to our employees, consultants, and non-employee directors. We had 912,774 shares authorized for issuance under our stock option plans as of June 30, 2007 of which 242,635 shares remain available for future issuance. Stock options issued under these plans are granted with an exercise price at or above the fair market value of the underlying common stock on the date of grant and generally expire five or ten years from the date of grant. Employee stock options granted during 2007 generally vest 25 percent each year over a four-year period, while non-employee director options vest 25 percent each quarter over a one-year period.

Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123R, *Share-Based Payment* (SFAS 123R), using the modified prospective transition method. Under this transition method, compensation cost recognized in the three and six months ended June 30, 2007 and 2006 includes compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with SFAS 123R. All options granted prior to January 1, 2006 were fully vested. We recognized stock- based compensation expense of approximately $139,000 and $211,000 during the three months ended June 30, 2007 and 2006, respectively, and $341,000 and $402,000 during the six months ended June 30, 2007 and 2006, respectively.

The fair value of stock options granted was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Dividend yield	0.0%	0.0%	0.0%	0.0%
Expected volatility	34.4%	36.5%	34.4%	40.3%
Risk-free interest rate	4.9%	5.0%	4.9%	4.9%
Expected life (in years)	3.8	3.9	3.8	4.3
Weighted average fair value per option granted	$ 6.45	$ 4.44	$ 6.45	$ 4.23

The following table summarizes activity under our stock award plans during the six months ended June 30, 2007:

	Shares Under Option	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value

Outstanding options at December 31, 2006	631,589	$	10.65			
Granted	76,750		19.36			
Forfeited	(26,950)		15.76			
Exercised	(11,250)		7.18			
Outstanding options at June 30, 2007	670,139	$	11.50	5.1 years	$	4,629,000
Exercisable at June 30, 2007	475,826	$	9.24	5.4 years	$	4,292,000

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KONA GRILL, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

The intrinsic value of options exercised during the six months ended June 30, 2007 and 2006 was approximately $121,000 and $392,000, respectively. As of June 30, 2007, there was approximately $844,000 of total unrecognized stock-based compensation expense related to unvested share-based compensation arrangements, which is expected to be recognized over a weighted average period of 2.5 years.

6. Comprehensive Income (Loss)

Comprehensive income (loss) is defined as the aggregate change in stockholders equity, excluding changes in ownership interests. It is the sum of net income (loss) and changes in unrealized gains or losses on available-for-sale securities. The components of comprehensive income (loss), net of related tax, for the three and six months ended June 30, 2007 and 2006 were as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
Net income (loss)	$ 313	$ (303)	$ (230)	$ (1,191)
Net unrealized gains (losses) on available-for-sale securities	1	(2)	1	(17)
Total comprehensive income (loss)	$ 314	$ (305)	$ (229)	$ (1,208)

7. Income Taxes

We adopted the provisions of FIN 48, *Accounting for Uncertainty in Income Taxes*, on January 1, 2007. As a result of the implementation of FIN 48, we recognized an immaterial adjustment in the liability for unrecognized income tax benefits, which was accounted for as an increase to the January 1, 2007 accumulated deficit balance. At the adoption date of January 1, 2007, we had $65,000 of unrecognized tax benefits. Future changes in the unrecognized tax benefit are not expected to have a material impact on the effective tax rate due to the existence of a valuation allowance.

We recognize interest and penalties related to uncertain tax positions in income tax expense. There have been no material changes in the amounts of our unrecognized tax benefits or interest and penalties related to uncertain tax positions since we adopted FIN 48.

We are subject to U.S. federal income tax as well as income tax of multiple state jurisdictions. Federal income tax returns for 2003 through 2006 remain open to examination, while state and local income tax returns for 2002 through 2006 remain open to examination.

8. Commitments and Contingencies

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 our results of operations or financial condition.

Item 2. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

This information should be read in conjunction with the unaudited consolidated financial statements and notes thereto included in Item 1 of Part I of this Quarterly Report and the audited consolidated financial statements and notes thereto and Management s Discussion and Analysis of Financial Condition and Results of Operations for the year ended December 31, 2006 contained in our 2006 Annual Report on Form 10-K. The following discussion contains forward-looking statements that involve risks, uncertainties, and assumptions. Forward-looking statements include statements regarding our expectations, anticipation, intentions, beliefs, or strategies regarding the future. Forward-looking statements relating to our future economic performance, plans and objectives for future operations, and projections of revenue and other financial items are based on our beliefs as well as assumptions made by and information currently available to us. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of a variety of factors, including those set forth under Item 1A, Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2006 and other reports filed from time to time with the Securities and Exchange Commission.

Overview

We currently own and operate 16 restaurants located in ten states, including our restaurant in Troy, Michigan which opened during the second quarter. We offer freshly prepared food, personalized service, and a contemporary ambiance that create a satisfying yet affordable dining experience that we believe exceeds many traditional casual dining restaurants with which we compete. Our high-volume upscale casual restaurants feature a diverse selection of mainstream American dishes as well as a variety of appetizers and entrees with an international influence, including an extensive selection of sushi items. Our menu items are freshly prepared and incorporate over 40 signature sauces and dressings that we make from scratch, creating broad-based appeal for the lifestyle and taste trends of a diverse group of guests. Our menu is standardized for all of our restaurants allowing us to deliver consistent quality meals and service. We believe that our extensive menu and generous portions offer our guests an attractive price-value proposition.

We continue to follow a disciplined growth plan focused largely on expanding our presence in new markets. To date, we have funded our restaurant development, working capital, and general corporate needs with cash flows from operations, loans from affiliates, the sale of common and preferred stock, receipt of landlord tenant improvement allowances, and borrowings under equipment term loans. We plan to open four new restaurants during 2007, of which one restaurant in Austin, Texas and another restaurant in Troy, Michigan have already opened. The two restaurants scheduled to open in the second half of 2007 are located in Baton Rouge, Louisiana and Stamford, Connecticut. Our goal is for our new restaurants to generate average annual unit volumes of $4.5 million following 24 months of operations. We believe our typical new restaurants experience gradually increasing unit volumes as guests begin to discover our concept and we begin to generate market awareness. Our restaurants are also subject to seasonal fluctuations. Despite our limited operating history, we have identified that sales in most of our restaurants typically are higher during the spring and summer months and winter holiday season.

We experience various trends in our operating cost structure. Cost of sales, labor, occupancy, and other operating expenses for our restaurants open at least 12 months generally trend consistent with restaurant sales, and we analyze those costs as a percentage of restaurant sales. We anticipate that our new restaurants will take approximately six months to achieve operating efficiencies as a result of challenges typically associated with 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 restaurant sales to be higher when we open a new restaurant, but decrease as a percentage of restaurant sales as the restaurant matures and as the restaurant management and employees become more efficient operating that unit. The majority of our general and administrative costs are fixed costs. We expect our general and administrative spending to increase as we add corporate personnel and infrastructure to support our growth and comply with the requirements associated with being a public company. However, we expect our general and administrative costs to decrease as a percentage of restaurant sales as we leverage these investments and realize the benefits of higher sales volumes.

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Key Measures We Use to Evaluate Our Company

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

Number of Restaurant Openings. Number of restaurant openings reflects the number of restaurants opened during a particular reporting period.

Same-Store Sales Growth. Same-store sales growth reflects the periodic change in restaurant sales for the comparable restaurant base. In calculating same-store sales growth, we include a restaurant in the comparable restaurant base after it has been in operation for more than 18 months. Same-store sales growth can be generated by an increase in guest 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.

Average Weekly Sales. Average weekly sales represents the average of restaurant sales measured over consecutive Monday through Sunday time periods.

Average Unit Volume. Average unit volume represents the average restaurant sales for all of our restaurants open for at least 12 months before the beginning of the period measured.

Sales Per Square Foot. Sales per square foot represents the restaurant sales for our restaurants open for at least 12 months, divided by the total square feet for such restaurants.

Restaurant Operating Profit. Restaurant operating profit is defined as restaurant sales minus cost of sales, labor, occupancy, and restaurant operating expenses. Restaurant operating profit does not include general and administrative expenses, depreciation and amortization, and 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. We use restaurant operating profit as a percentage of restaurant sales as a key metric to evaluate our restaurants financial performance compared with our competitors.

Key Financial Definitions

Restaurant Sales. Restaurant sales include gross food and beverage sales, net of promotions and discounts.

Cost of Sales. Cost of sales consists of food and bevera STYLE="text-transform: none">tanley Finance LLC

Buffered PLUS Based on the Value of the EURO STOXX 50® Index due October 5, 2020

Buffered Performance Leveraged Upside Securities℠

Principal at Risk Securities

Taxation" in the accompanying product supplement for PLUS and consult their tax advisers regarding all aspects of the U.S. federal income tax consequences of an investment in the Buffered PLUS, including possible alternative treatments, the issues presented by the aforementioned notice and any tax consequences arising under the laws of any state, local or non-U.S. taxing jurisdiction.

The discussion in the preceding paragraphs under "Tax considerations" and the discussion contained in the section entitled "United States Federal Taxation" in the accompanying product supplement for PLUS, insofar as they purport to describe provisions of U.S. federal income tax laws or legal conclusions with respect thereto, constitute the full opinion of Davis Polk & Wardwell LLP regarding the material U.S. federal tax consequences of an investment in the

	Buffered PLUS.
Trustee:	The Bank of New York Mellon
Calculation agent:	MS & Co.
Use of proceeds and hedging:	The proceeds from the sale of the Buffered PLUS will be used by us for general corporate purposes. We will receive, in aggregate, $10 per Buffered PLUS issued, because, when we enter into hedging transactions in order to meet our obligations under the Buffered PLUS, our hedging counterparty will reimburse the cost of the agent's commissions. The costs of the Buffered PLUS borne by you and described beginning on page 2 above comprise the agent's commissions and the cost of issuing, structuring and hedging the Buffered PLUS. On or prior to the pricing date, we hedged our anticipated exposure in connection with the Buffered PLUS by entering into hedging transactions with our affiliates and/or third party dealers. We expect our hedging counterparties to have taken positions in stocks of the underlying index and in futures and options contracts on the underlying index and any component stocks of the underlying index listed on major securities markets. Such purchase activity could have increased the value of the underlying index on the pricing date, and, therefore, could have increased the value at or above which the underlying index must close on the valuation date so that investors do not suffer a loss on their initial investment in the Buffered PLUS. In addition, through our affiliates, we are likely to modify our hedge position throughout the term of the Buffered PLUS, including on the valuation date, by purchasing and selling the stocks constituting the underlying index, futures or options contracts on the underlying index or its component stocks listed on major securities markets or positions in any other available securities or instruments that we may wish to use in connection with such hedging activities. As a result, these entities may be unwinding or adjusting hedge positions during the term of the Buffered PLUS, and the hedging strategy may involve greater and more frequent dynamic adjustments to the hedge as the valuation date approaches. We cannot give any assurance that our hedging activities will not affect the value of the underlying index, and, therefore, adversely affect the value of the Buffered PLUS or the payment you will receive at maturity. For further information on our use of proceeds and hedging, see "Use of Proceeds and Hedging" in the accompanying product supplement for PLUS.
Benefit plan investor considerations:	Each fiduciary of a pension, profit-sharing or other employee benefit plan subject to Title I of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") (a "Plan"), should consider the fiduciary standards of ERISA in the context of the Plan's particular circumstances before authorizing an investment in the Buffered PLUS. Accordingly, among other factors, the fiduciary should consider whether the investment would satisfy the prudence and diversification requirements of ERISA and would be consistent with the documents and instruments governing the Plan. In addition, we and certain of our affiliates, including MS & Co., may each be considered a "party in interest" within the meaning of ERISA, or a "disqualified person" within the meaning of the Internal Revenue Code of 1986, as amended (the "Code"), with respect to many Plans, as well as many individual retirement accounts and Keogh plans (such accounts and plans, together with other plans, accounts and arrangements subject to Section 4975 of the Code, also "Plans"). ERISA Section 406 and Code Section 4975 generally prohibit transactions between Plans and parties in interest or disqualified persons. Prohibited transactions within the meaning of ERISA or the Code would likely arise, for example, if the Buffered PLUS are acquired by or with the assets of a Plan with respect to which MS & Co. or any of its affiliates is a service provider or other party in interest, unless the Buffered PLUS are acquired pursuant to an exemption from the "prohibited transaction" rules. A

violation of these “prohibited transaction” rules could result in an excise tax or other liabilities under ERISA and/or Section 4975 of the Code for those persons, unless exemptive relief is available under an applicable statutory or administrative exemption.

The U.S. Department of Labor has issued five prohibited transaction class exemptions (“PTCEs”) that may provide exemptive relief for direct or indirect prohibited transactions resulting from the purchase or holding of the Buffered PLUS. Those class exemptions are PTCE 96-23 (for certain transactions determined by in-house asset managers), PTCE 95-60 (for certain transactions involving insurance company general accounts), PTCE 91-38 (for certain transactions involving bank collective investment funds), PTCE 90-1 (for certain transactions involving insurance company separate accounts) and PTCE 84-14 (for certain transactions determined by independent qualified professional asset managers). In addition, ERISA Section 408(b)(17) and Section 4975(d)(20) of the Code provide an exemption for the purchase and sale of securities and the related lending transactions, provided that neither the issuer of the securities nor any of its affiliates has or exercises any discretionary authority or control or renders any investment advice with respect to the assets of the Plan involved in the transaction and provided further that the Plan pays no more, and receives no less, than “adequate consideration” in connection with the transaction (the so-called “service provider” exemption). There can be no assurance that any of these class or statutory exemptions will be available with respect to transactions involving the Buffered PLUS.

Because we may be considered a party in interest with respect to many Plans, the Buffered PLUS may not be purchased, held or disposed of by any Plan, any entity whose underlying assets include “plan assets” by reason of any Plan’s investment in the entity (a “Plan Asset Entity”) or any person investing “plan assets” of any Plan, unless such purchase, holding or disposition is eligible for exemptive relief, including relief available under PTCEs 96-23, 95-60, 91-38, 90-1, 84-14 or the service provider exemption or such purchase, holding or disposition is otherwise not prohibited. Any purchaser, including any fiduciary purchasing on behalf of a Plan, transferee or holder of the Buffered PLUS will be deemed to have represented, in its corporate and its fiduciary capacity, by its purchase and holding of the Buffered PLUS that either (a) it is not a Plan or a Plan Asset Entity and is not purchasing such Buffered PLUS on behalf of or with “plan assets” of any Plan or with any assets of a governmental, non-U.S. or church plan that is subject to any federal, state, local or non-U.S. law that is substantially similar to the provisions of Section 406 of ERISA or Section 4975 of the Code (“Similar Law”) or (b) its purchase, holding and disposition of these Buffered PLUS will not constitute or result in a non-exempt prohibited transaction under Section 406 of ERISA or Section 4975 of the Code or violate any Similar Law.

Due to the complexity of these rules and the penalties that may be imposed upon persons involved in non-exempt prohibited transactions, it is particularly important that fiduciaries or other persons considering purchasing the Buffered PLUS on behalf of or with “plan assets” of any Plan consult with their counsel regarding the availability of exemptive relief.

The Buffered PLUS are contractual financial instruments. The financial exposure provided by the Buffered PLUS is not a substitute or proxy for, and is not intended as a substitute or proxy for, individualized investment management or advice for the benefit of any purchaser or holder of the Buffered PLUS. The Buffered PLUS have not been designed and will not be administered in a manner intended to reflect the individualized needs and objectives of any purchaser or holder of the Buffered PLUS.

Each purchaser or holder of any Buffered PLUS acknowledges and agrees that:

(i) the purchaser or holder or its fiduciary has made and shall make all investment decisions for the purchaser or holder and the purchaser or holder has not relied and shall not rely in any way upon us or our affiliates to act as a fiduciary or adviser of the purchaser or holder with respect to (A) the design and terms of the Buffered PLUS, (B) the purchaser or holder's investment in the Buffered PLUS, or (C) the exercise of or failure to exercise any rights we have under or with respect to the Buffered PLUS;

(ii) we and our affiliates have acted and will act solely for our own account in connection with (A) all transactions relating to the Buffered PLUS and (B) all hedging transactions in connection with our obligations under the Buffered PLUS;

(iii) any and all assets and positions relating to hedging transactions by us or our affiliates are assets and positions of those entities and are not assets and positions held for the benefit of the purchaser or holder;

(iv) our interests are adverse to the interests of the purchaser or holder; and

(v) neither we nor any of our affiliates is a fiduciary or adviser of the purchaser or holder in connection with any such assets, positions or transactions, and any information that we or any of our affiliates may provide is not intended to be impartial investment advice.

Each purchaser and holder of the Buffered PLUS has exclusive responsibility for ensuring that its purchase, holding and disposition of the Buffered PLUS do not violate the prohibited transaction rules of ERISA or the Code or any Similar Law. The sale of any Buffered PLUS to any Plan or plan subject to Similar Law is in no respect a representation by us or any of our affiliates or representatives that such an investment meets all relevant legal requirements with respect to investments by plans generally or any particular plan, or that such an investment is appropriate for plans generally or any particular plan. In this regard, neither this discussion nor anything provided in this document is or is intended to be investment advice directed at any potential Plan purchaser or at Plan purchasers generally and such purchasers of the Buffered PLUS should consult and rely on their own counsel and advisers as to whether an investment in the Buffered PLUS is suitable.

However, individual retirement accounts, individual retirement annuities and Keogh plans, as well as employee benefit plans that permit participants to direct the investment of their accounts, will not be permitted to purchase or hold the Buffered PLUS if the account, plan or annuity is for the benefit

	of an employee of Morgan Stanley, Morgan Stanley Wealth Management or a family member and the employee receives any compensation (such as, for example, an addition to bonus) based on the purchase of the Buffered PLUS by the account, plan or annuity.
Additional considerations:	Client accounts over which Morgan Stanley, Morgan Stanley Wealth Management or any of their respective subsidiaries have investment discretion are not permitted to purchase the Buffered PLUS, either directly or indirectly.
Supplemental information regarding	The agent may distribute the Buffered PLUS through Morgan Stanley Smith Barney LLC ("Morgan Stanley

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Morgan Stanley Finance LLC

Buffered PLUS Based on the Value of the EURO STOXX 50® Index due October 5, 2020

Buffered Performance Leveraged Upside Securities℠

Principal at Risk Securities

	Wealth Management"), as selected dealer, or other dealers, which may include Morgan Stanley & Co. International plc ("MSIP") and Bank Morgan Stanley AG. Morgan Stanley Wealth Management, MSIP and Bank Morgan Stanley AG are affiliates of ours. Selected dealers, including Morgan Stanley Wealth Management, and their financial advisors will collectively receive from the agent, Morgan Stanley & Co. LLC, a fixed sales commission of $0.20 for each Buffered PLUS they sell. In addition, Morgan Stanley Wealth Management will receive a structuring fee of $0.05 for each Buffered PLUS.
plan of distribution; conflicts of interest:	MS & Co. is an affiliate of MSFL and a wholly owned subsidiary of Morgan Stanley, and it and other affiliates of ours expect to make a profit by selling, structuring and, when applicable, hedging the Buffered PLUS.
	MS & Co. will conduct this offering in compliance with the requirements of FINRA Rule 5121 of the Financial Industry Regulatory Authority, Inc., which is commonly referred to as FINRA, regarding a FINRA member firm's distribution of the securities of an affiliate and related conflicts of interest. MS & Co. or any of our other affiliates may not make sales in this offering to any discretionary account. See "Plan of Distribution (Conflicts of Interest)" and "Use of Proceeds and Hedging" in the accompanying product supplement for PLUS.
Validity of the Buffered PLUS:	In the opinion of Davis Polk & Wardwell LLP, as special counsel to MSFL and Morgan Stanley, when the Buffered PLUS offered by this pricing supplement have been executed and issued by MSFL, authenticated by the trustee pursuant to the MSFL Senior Debt Indenture (as defined in the accompanying prospectus) and delivered against payment as contemplated herein, such Buffered PLUS will be valid and binding obligations of MSFL and the related guarantee will be a valid and binding obligation of Morgan Stanley, enforceable in accordance with their terms, subject to applicable bankruptcy, insolvency and similar laws affecting creditors' rights generally, concepts of reasonableness and equitable principles of general applicability (including, without limitation, concepts of good faith, fair dealing and the lack of bad faith), provided that such counsel expresses no opinion as to (i) the effect of fraudulent conveyance, fraudulent transfer or similar provision of applicable law on the conclusions expressed above and (ii) any provision of the MSFL Senior Debt Indenture that purports to avoid the effect of fraudulent conveyance, fraudulent transfer or similar provision of applicable law by limiting the amount of Morgan Stanley's obligation under the related guarantee. This opinion is given as of the date hereof and is limited to the laws of the State of New York, the General Corporation Law of the State of Delaware and the Delaware Limited Liability Company Act. In addition, this opinion is subject to customary assumptions about the trustee's authorization, execution and delivery of the MSFL Senior Debt Indenture and its authentication of the

Buffered PLUS and the validity, binding nature and enforceability of the MSFL Senior Debt Indenture with respect to the trustee, all as stated in the letter of such counsel dated November 16, 2017, which is Exhibit 5-a to the Registration Statement on Form S-3 filed by Morgan Stanley on November 16, 2017.

Contact: Morgan Stanley Wealth Management clients may contact their local Morgan Stanley branch office or our principal executive offices at 1585 Broadway, New York, New York 10036 (telephone number (866) 477-4776). All other clients may contact their local brokerage representative. Third-party distributors may contact Morgan Stanley Structured Investment Sales at (800) 233-1087.

Morgan Stanley and MSFL have filed a registration statement (including a prospectus, as supplemented by the product supplement for PLUS and the index supplement) with the Securities and Exchange Commission, or SEC, for the offering to which this communication relates. You should read the prospectus in that registration statement, the product supplement for PLUS, the index supplement and any other documents relating to this offering that Morgan Stanley and MSFL have filed with the SEC for more complete information about Morgan Stanley, MSFL and this offering. You may get these documents without cost by visiting EDGAR on the SEC web site at.www.sec.gov. Alternatively, Morgan Stanley, MSFL, any underwriter or any dealer participating in the offering will arrange to send you the product supplement for PLUS, index supplement and prospectus if you so request by calling toll-free 1-(800)-584-6837.

Where you can find more information:

You may access these documents on the SEC web site at.www.sec.gov as follows:

Product Supplement for PLUS dated November 16, 2017

Index Supplement dated November 16, 2017

Prospectus dated November 16, 2017

Terms used but not defined in this document are defined in the product supplement for PLUS, in the index supplement or in the prospectus.

"Performance Leveraged Upside Securities[SM]" and "PLUS[SM]" are our service marks.

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