

GRILL CONCEPTS INC
Form 10-K
March 30, 2007
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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, 2006

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

For the transition period from _____ to _____.

Commission File No. 0-23326

GRILL CONCEPTS, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of

incorporation or organization)

11661 San Vicente Blvd., Suite 404, Los Angeles, California 90049

(Address of Principal Executive Offices) (Zip Code)

Registrant's Telephone Number, Include Area Code: (310) 820-5559

Securities Registered Under Section 12(b) of the Exchange Act:

13-3319172
(I.R.S. Employer
Identification Number)

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Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, \$0.00004 par value	The Nasdaq Stock Market LLC

Securities Registered Under Section 12(g) of the Exchange Act:

None

(Title of Class)

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 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K 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 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 Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant, based on the closing price on the NASDAQ Capital Market, as of the close of business June 25, 2006 was approximately \$18.6 million.

Number of shares outstanding of the registrant's common stock, \$0.00004 par value, as of March 10, 2007: 6,420,212 shares.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive annual proxy statement to be filed within 120 days of the Registrant's fiscal year ended December 31, 2006 are incorporated by reference into Part III.

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PART I

This Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. The Company's actual results could differ materially from those set forth in the forward-looking statements. Certain factors that might cause such a difference are discussed in Item 1A. Risk Factors.

ITEM 1. BUSINESS

Except as expressly indicated or unless the context otherwise requires, as used herein, the Company, GCI, we, our, or us, means Grill Concepts, Inc., a Delaware corporation and its subsidiaries.

General

Grill Concepts, Inc., and its subsidiaries, develops, owns, operates, manages and licenses full-service upscale casual dining restaurants under the name Daily Grill and fine dining restaurants under the name The Grill on the Alley.

The Company was incorporated under the laws of the State of Delaware in November of 1985. Since our acquisition of Grill Concepts, Inc., a California corporation, in March of 1995, we have focused principally on the expansion of the Daily Grill (the Daily Grill) and The Grill on the Alley (the Grill) restaurant formats of GCI.

At December 31, 2006, we owned and operated 17 restaurants (Company Restaurants) and managed or licensed 8 additional restaurants. 12 Daily Grill restaurants and 5 The Grill on the Alley restaurants are owned and operated, 6 Daily Grill restaurants are managed and we license 2 Daily Grill restaurants. With the exception of 3 The Grill on the Alley restaurants, and 3 Daily Grill restaurants that are operated by partnerships, all of the Daily Grill and The Grill on the Alley restaurants, which were owned and operated at December 31, 2006, were solely owned and operated by us.

In 2001, we entered into a strategic alliance with Starwood Hotels and Resorts Worldwide, Inc. to jointly develop restaurant properties in Starwood hotels. Management believes that the opening of restaurants in hotel properties in strategic markets will help further establish brand name recognition for the opening of additional restaurants in those markets.

Recent Developments

During 2006, we continued to pursue a strategic growth plan whereby the Company plans to open, and/or convert, and operate, and/or manage, Daily Grill and Grill on the Alley restaurants in hotel properties, and non-hotel based restaurants, in strategic markets throughout the United States. During 2006, we undertook efforts to expand the pace of our restaurant openings.

In order to provide financing to support the planned accelerated pace of restaurant openings, in March 2006, we entered into a financing agreement with Diamond Creek Investment Partners, LLC, at which time our previous line of credit was terminated. The Credit Agreement provides for a revolving term loan of the lesser of (a) \$8.0 million, or (b) 2.25 times our trailing 12 month EBITDA. In December 2006, the Credit Agreement was amended to increase the available credit thereunder from \$8.0 million to \$12.0 million.

In June 2006, following our annual stockholders meeting, Robert Spivak retired as our President and Chief Executive Officer and Philip Gay, our Executive Vice President and Chief

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Financial Officer, assumed the positions of President and Chief Executive Officer. In July 2006, we hired a new Chief Financial Officer.

In September 2006, we entered into an agreement with Hotel Restaurant Properties, Inc. and certain affiliates (HRP) pursuant to which we acquired certain rights and interests of HRP under an August 1998 agreement whereby HRP had the exclusive rights to identify hotel-based locations for our restaurants and received a portion of the profits from those restaurants. Pursuant to that agreement, effective June 30, 2006, substantially all rights of HRP relating to subject restaurants were terminated and we agreed to pay \$2,771,133 on June 30, 2007 plus certain additional payments to be made until June 30, 2007 in the amount of \$294,151.

During 2006, we opened one restaurant, a 100% owned Grill on the Alley, which opened in July 2006 in Dallas, Texas and announced the planned opening of two additional restaurants, including a managed hotel based Daily Grill in Memphis, Tennessee on which construction began in November 2006 and which is scheduled to open during the second quarter of 2007, and a managed hotel based Daily Grill in Seattle, Washington on which construction began in January 2007 and which is scheduled to open during the summer of 2007. In addition, during the first quarter of 2007, we announced the planned opening of three additional restaurants, including a 100% owned Daily Grill in Austin, Texas on which construction began in January 2007 and which is scheduled to open during the third quarter of 2007, a 100% owned Daily Grill in Dallas, Texas, which is scheduled to open in late 2008, and a 100% Daily Grill in Phoenix, Arizona, which is scheduled to open in late 2008.

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The following table sets forth unaudited restaurant count information for all restaurants.

	2006	2005
Number of restaurants:		
Daily Grill restaurants:		
Company Restaurants:		
Beginning of year	12	11
Restaurant opening		2
Restaurant closings		(1)
End of year	12	12
Managed or Licensed Restaurants:		
Beginning of year	8	8
Restaurant openings		
Restaurant closings		
End of year	8	8
Total Daily Grill restaurants:		
Beginning of year	20	19
Restaurant openings		2
Restaurants closings		(1)
End of year	20	20
Grill on the Alley restaurants:		
Company Restaurants:		
Beginning of year	4	4
Restaurant openings	1	
End of year	5	4
Total Grill on the Alley restaurants:		
Beginning of year	4	4
Restaurant openings	1	
End of year	5	4
Total restaurants:		
Beginning of year	24	23
Restaurant openings	1	2
Restaurants closings		(1)
End of year	25	24

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The following table sets forth unaudited weekly sales per restaurant, comparable restaurant sales information for restaurants open twelve months in both periods, and total consolidated sales information during 2006 and 2005 by restaurant concept for Company Restaurants (as fiscal year 2006 consisted of 53 weeks, the results of this extra week are also shown):

	2006 (53 weeks)	2006 (52 weeks)	2005
Weighted average weekly sales per restaurant:			
Daily Grill restaurants:			
Company Restaurants	\$ 63,647	\$ 63,731	\$ 59,456
Grill on the Alley restaurants:			
Company Restaurants	\$ 92,180	\$ 92,124	\$ 85,110
Change in comparable restaurant sales:			
Daily Grill restaurants			
Company Restaurants	7.5%	5.5%	1.1%
Grill on the Alley restaurants			
Company Restaurants	14.7%	12.3%	9.8%
Total consolidated sales: (in thousands)			
Daily Grill	\$ 40,479	\$ 39,768	\$ 37,003
Grill on the Alley	22,171	21,680	17,703
Total consolidated sales	\$ 62,650	\$ 61,448	\$ 54,706

We earn management and license fee revenue based on a percentage of gross sales at restaurants under management and licensing arrangements. Our management and license fee revenue typically is earned at a rate of five to eight percent of reported gross sales at these restaurants. In addition to the base fee we also earn incentive fees based on net income that is reported as management and license fees revenue. The gross sales of managed and licensed restaurants are not included in our consolidated statements of operations. However, we consider the disclosure of these gross sales to be a key indicator of brand strength and important to understanding how changes in gross sales at the managed and licensed restaurants impact our revenue.

Sales at non-Company owned GCI-branded restaurants, categorized as, managed and licensed restaurants were as follows:

(in thousands)	2006	2005
Gross Sales		
Managed Daily Grill restaurants	\$ 21,768	\$ 19,242
Licensed Daily Grill restaurants	7,346	7,852
	\$ 29,114	\$ 27,094
Management and license fees	\$ 1,940	\$ 1,683
Percent of gross sales	6.7%	6.2%

Restaurant Concepts**Daily Grill Restaurants**

Background. At December 31, 2006, we, through our subsidiaries, owned and operated, managed or licensed 20 Daily Grill restaurants in Southern and Northern California; the Washington, D.C. metropolitan region; Houston, Texas; Portland, Oregon; and Skokie, Illinois.

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Daily Grill restaurants are patterned after The Grill on the Alley in Beverly Hills. See The Grill on the Alley. After successfully operating The Grill on the Alley for a number of years, in 1988, the founders of The Grill on the Alley decided to expand on that theme by opening the first Daily Grill restaurant. Daily Grill, in an effort to offer the same qualities that made The Grill on the Alley successful, but at more value oriented prices, adopted six operating principles that characterize each Daily Grill restaurant: high quality food, excellent service, good value, consistency, appealing atmosphere and cleanliness. GCI emphasized those principles in an effort to create a loyal patron who will be a regular at its restaurants.

Restaurant Sites. Current and planned Daily Grill restaurants can be characterized as either owned, in part or in whole, managed or licensed and as either hotel based or based in shopping malls and other commercial and retail properties.

Daily Grill locations which are opened, or are scheduled to open in the following months and years, are owned, managed or licensed as indicated and, where indicated, are located in the referenced hotels:

Location	Opened or Scheduled Opening	Ownership Interest, Licensed or Managed
Brentwood, California	September 1988	100%
Newport Beach, California	April 1991	100%
Studio City, California	August 1993	100%
Palm Desert, California	January 1994	100%
Irvine, California	September 1996	100%
Los Angeles International Airport	January 1997	Licensed
Washington, D.C.	March 1997	100%
Tysons Corner, Virginia	October 1998	100%
Burbank, California (Marriott Hotel)	January 1999	Managed
Washington, D.C. (Georgetown Inn)	April 1999	Managed
Universal CityWalk, California	May 1999	50%
Skokie, Illinois (North Shore Skokie Hotel)	September 2000	Licensed
San Francisco, California (Handlery Union Square Hotel)	February 2002	Managed
Houston, Texas (Westin Galleria)	July 2002	Managed
El Segundo (South Bay), California	January 2003	50.1%
Portland, Oregon (Portland Westin)	September 2003	Managed
Bethesda, Maryland (Hyatt Hotel)	January 2004	100%
Long Beach, California (Hilton Hotel)	November 2004	Managed
Santa Monica, California	March 2005	100%
Downtown Los Angeles, California	May 2005	58.4%
Memphis, Tennessee (Westin Hotel)	April 2007	Managed
Seattle, Washington (Sheraton Hotel)	Summer 2007	Managed
Austin, Texas	Summer 2007	100%
Dallas, Texas	Late 2008	100%
Phoenix, Arizona	Late 2008	100%

Of the restaurants operated at December 31, 2006, 8 were located in, or adjoin, hotel properties and, of the 12 restaurants owned at December 31, 2006, 9 were owned 100% and 3 were owned at levels ranging from 50% to 58.4%.

Existing non-hotel based Daily Grill restaurants range in size from 4,500 to 7,600 square feet of which approximately 30% is devoted to kitchen and service areas and seat between 140 and 300

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persons. Our costs for existing non-hotel based restaurants, including leasehold improvements, furniture, fixtures and equipment and pre-opening expenses, have averaged \$375 per foot, less tenant improvement allowances.

Existing hotel based Daily Grill restaurants range in size from 3,600 to 8,000 square feet of which approximately 30% is devoted to kitchen and service areas and seat between 140 and 270 persons. Management anticipates that additional hotel based Daily Grill restaurants will require minimal capital investment on our part. However, each hotel restaurant arrangement will be negotiated separately and our capital investment may vary widely. Our portion of opening costs of existing hotel restaurants, including leasehold improvements, furniture, fixtures and equipment and pre-opening expenses, have ranged from nothing to \$513,000 per restaurant.

Menu and Food Preparation. Each Daily Grill restaurant offers a similar extensive menu featuring over 100 items. The menu was designed to be reminiscent of the selection available at American-style grill restaurants of the 1930 s and 1940 s. During 2005 we redesigned the menu placing a greater emphasis on steaks, chops and seafood. Daily Grill offers genuine Angus steaks and chops, as well as, such signature items as Cobb salad, Caesar salad, meatloaf with mashed potatoes, chicken pot pie, hamburgers, fresh fruit cobbler and key lime pie. The emphasis at the Daily Grill is on freshly prepared American food served in generous portions.

Entrees range in price, subject to regional differences, from \$8.95 for a hamburger to \$29.95 for a char-broiled filet steak with all the trimmings. The average lunch check is \$16.98 per person and the average dinner check is \$26.89 per person, including beverage. Daily Grill restaurants also offer a children s menu with reduced portions of selected items at reduced prices. All of the existing Daily Grill restaurants offer a full range of beverages, including beer, wine and full bar service. During the year ended December 31, 2006, food and non-alcoholic beverage sales constituted approximately 83% of the total restaurant revenues for the Daily Grill restaurants, with alcoholic beverages accounting for the remaining 17%.

Atmosphere and Service. Most Daily Grill restaurants are open for lunch and dinner seven days a week and for Sunday brunch. Several are open for breakfast as well, especially in hotel locations. Each Daily Grill location is designed to provide the sense and feel of comfort. In the tradition of an old-time American-style grill, the setting is very open with a mix of booths and tables. Several of the restaurants have counters for singles to feel comfortable. A number of the Daily Grill restaurants have private dining rooms for banquets or additional seating. Each restaurant emphasizes the quality and freshness of Daily Grill food dishes in addition to the cleanliness of operations. The dining area is well-lit and is characterized by a high energy level. Reservations are accepted but not required.

The Grill on the Alley Restaurants

Background. At December 31, 2006, we, through our subsidiaries, owned and operated 5 The Grill on the Alley restaurants (Grill).

The original Grill is a fine dining Beverly Hills restaurant, which opened in 1984 and served as the model for the Daily Grill restaurants. The Grill is set in the traditional style of the old-time grills of New York and San Francisco, with black-and-white marbled floors and polished wooden booths. The Grill offers five-star American cuisine and uncompromising service in a comfortable, dignified atmosphere.

In April of 1996, we acquired the original Grill from a partnership, the managing partner of which was controlled by our then principal shareholders and directors.

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Restaurant Sites. At December 31, 2006, we owned and operated 5 Grill restaurants, three of which were non-hotel based facilities and two of which were hotel-based facilities.

Grill locations opened, or scheduled to open, in the following months and years, are owned as indicated and, where indicated, in the referenced hotels:

Location	Opened	Ownership Interest
Beverly Hills, California	January 1984	100%
San Jose, California (Fairmont Hotel)	May 1998	50.05%
Chicago, Illinois (Westin Hotel)	June 2000	60%
Hollywood, California	November 2001	51%
Dallas, Texas	July 2006	100%

Existing non-hotel based Grill restaurants range in size from approximately 4,200 to 7,200 square feet of which approximately 35% is devoted to kitchen and service areas and seat 120 to 260 guests.

Existing hotel based Grill restaurants range in size from approximately 6,500 to 9,250 square feet of which approximately 35% to 38% is devoted to kitchen and service areas and seat 280 to 300 guests.

Because of the unique nature of Grill restaurants, the size, seating capacity and opening costs of future sites will be unique to each location. Each hotel restaurant arrangement will be negotiated separately and our capital investment may vary widely. Total project costs of the existing hotel based restaurants, including leasehold improvements, furniture, fixtures and equipment and pre-opening expenses, have ranged from \$2.1 million to \$3.3 million.

Menu and Food Preparation. Each Grill restaurant offers a similar extensive menu featuring over 100 items. The menu was designed to be reminiscent of the selection available at fine American-style grill restaurants of the 1930 s and 1940 s, featuring prime steaks, fresh seafood from all over the world, freshly prepared salads and vegetables served in generous portions.

Entrees range in price from \$13.50 for a cheeseburger to \$42.50 for a prime porterhouse steak. The average lunch check is \$25.54 per person and the average dinner check is \$51.65 per person, including beverage. All of the existing Grill restaurants offer a full range of beverages, including beer, wine and full bar service. During the year ended December 31, 2006, food and non-alcoholic beverage sales constituted approximately 70% of the total restaurant revenues for Grill restaurants, with alcoholic beverages accounting for the remaining 30%.

Atmosphere and Service. Each Grill restaurant is open, at least, for lunch six days a week and dinner seven days a week. Each Grill location is designed to provide the sense and feel of comfort and elegance. In the tradition of an old-time American-style grill, the setting is an open kitchen adjacent to tables and booths. The open kitchen setting emphasizes the quality and freshness of food dishes in addition to the cleanliness of operations. The dining area is well-lit and is characterized by a high energy level. Reservations are accepted but are not required.

Operating Principles

All GCI employees are trained to treat each person who visits our restaurants as a guest and not merely a customer. Each server is responsible for assuring that his or her guest is satisfied. In keeping with the traditions of the past, each employee is taught that at our

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restaurants the guest is always right. Our policy is to accommodate all reasonable guest requests, ranging from substitutions of menu items to take-out orders.

In order to assure that our philosophy of guest service is adhered to, all employees from the kitchen staff to the serving staff undergo extensive training making each employee knowledgeable not only in our procedures and policies but in every aspect of operations. Our policy of promoting from within and providing access to senior management for all employees has produced a work force which works in a cooperative team approach and has resulted in an employee turnover rate of just over 58% per year for all employees, considerably below the industry average which management believes to be approximately 109%.

We believe that the familiarity and feeling of comfort, which accompanies dining in a familiar setting, with familiar food and quality service by familiar servers, produces satisfied customers who become regulars. Management believes that at the restaurants which have been open for over a year repeat business is significantly greater than the industry average, with many guests becoming regulars in the tradition of the neighborhood restaurant.

Proprietary recipes have been developed for substantially all of the items offered on our menus. The same recipes are used at each location and all chefs undergo extensive training in order to assure consistency and quality in the preparation of food. Virtually all of the menu items offered are cooked from scratch utilizing fresh food ingredients. Our management believes that our standards for ingredients and the preparation of menu items are among the most stringent in the industry.

Each Daily Grill restaurant has up to 7 cooks and each Grill has up to 8 cooks on duty during regular lunch and dinner hours to provide prompt, specialized service. Restaurant staff members utilize a point-of-sale computer system to monitor the movement of food items to assure prompt and proper service of guests and for fiscal control purposes.

Restaurant Management

We strive to maintain quality and consistency in our restaurants through the careful hiring, training and supervision of personnel and the adherence to standards relating to food and beverage preparation, maintenance of facilities and conduct of personnel. We believe that our concept and high sales volume enable us to attract quality, experienced restaurant management and hourly personnel. We have experienced a relatively low turnover at every level at our Daily Grill and Grill restaurants. See Operating Principles above.

Each Daily Grill and Grill restaurant, including both free standing and hotel-based restaurants, is managed by one general manager and up to four managers or assistant managers. Each restaurant also has one head chef and one or two sous chefs, depending on volume. On average, general managers have approximately five years experience in the restaurant industry and three years with us. The general manager has primary responsibility for the operation of the restaurant and reports directly to an Area Director who in turn reports to our Vice President of Operations. In addition to ensuring that food is prepared properly, the head chef is responsible for product quality, food costs and kitchen labor costs. Each restaurant has approximately 75 employees.

We maintain financial and accounting controls for each Daily Grill and Grill restaurant through the use of a point-of-sale computer system integrated with centralized accounting and management information systems. Inventory, expenses, labor costs, and cash are carefully monitored with appropriate control systems. Revenue and cost reports, including food and labor

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costs, are produced every night reflecting that day's business. The restaurant general manager, as well as home office management, receives these daily reports to ensure that problems can be identified and resolved in a timely manner. All employees receive appropriate training relating to cost, revenue and cash control. Financial management and accounting policies and procedures are developed and maintained by our Corporate Controller, Director of Information Systems, and Chief Financial Officer.

All managers participate in a comprehensive eight-week training program during which they are prepared for overall management of the dining room. The program includes topics such as food quality and preparation, guest service, food and beverage service, safety policies and employee relations. In addition, we have developed training courses for assistant managers and chefs. We typically have a number of employees involved in management training, so as to provide qualified management personnel for new restaurants. Our senior management meets regularly with each restaurant management team to discuss business issues, new ideas and revisit the manager's manual. Overall performance at each location is also monitored with shoppers' reports, guest comment cards and third party quality control reviews.

Servers at each restaurant participate in approximately eight days of training during which the employee works under close supervision, experiencing all aspects of the operations both in the kitchen and in the dining room. The extensive training is designed to improve quality and guest satisfaction. Certified trainers are given responsibility for training new employees and are rewarded with additional hourly pay plus other incentives. Management believes that such practice fosters a cooperative team approach that contributes to a lower turnover rate among employees. Representatives of home office management regularly visit the restaurants to ensure that our philosophy, strategy and standards of quality are being adhered to in all aspects of restaurant operations.

Purchasing

We have developed proprietary recipes for substantially all the items served at our Daily Grill and Grill restaurants. In order to assure quality and consistency at each of the Daily Grill and Grill restaurants, ingredients approved for the recipes are ordered on a unit basis by each restaurant's head chef from a supplier designated by our Culinary and Purchasing Departments. Because of the emphasis on cooking from scratch, virtually all food items are purchased fresh rather than frozen or pre-cooked, with one exception being bread, which is ordered from a central supplier that prepares the bread according to a proprietary recipe and delivers it daily to assure freshness. In order to reduce food preparation time and labor costs while maintaining consistency, we work with outside suppliers to produce a limited number of selected proprietary items such as salad dressings, soups and seasoning combinations.

We utilize our point-of-sale computer system to monitor inventory levels and expected sales, then order food ingredients daily based on such levels. We employ contract purchasing in order to lock in food prices and reduce short-term exposure to price increases. Our Director of Purchasing establishes general purchasing policies and is responsible for controlling the price and quality of all ingredients. The Director of Purchasing, the Senior Vice President Culinary and the Director of Research and Development, constantly monitor the quality, freshness and cost of all food ingredients. All essential food and beverage products are available, or upon short notice can be made available, from alternative qualified suppliers.

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Advertising and Marketing

Our marketing philosophy is to provide our guests with an exceptional and enjoyable dining experience that creates loyalty and frequent visits. Our marketing and promotional efforts have been fueled historically by our quality reputation, word of mouth, and positive local reviews. The Grill on the Alley and the Daily Grill concepts have been featured in articles and reviews in numerous local as well as national publications. We supplement our reputation with a program of marketing and public relations activities designed to keep the Daily Grill and Grill names before the public. Such activities include media advertising, direct mail promotions, a birthday club, e-mail marketing, as well as holiday and special interest events. We also support and participate in local charity campaigns. These activities are managed by a full time Director of Marketing. A toll free phone-in guest survey is utilized to gather guest feelings on their dining experience. During 2006, expenditures for advertising and promotion were approximately 1.3% of total consolidated sales revenues.

Restaurant Management and Licensing Activities

In addition to owning and operating Daily Grills and Grills, we, at December 31, 2006, provided contract management services for six hotel based Daily Grill restaurants at the Burbank Marriott, the Georgetown Inn, the Handlery Hotel, the Westin Galleria, the Portland Westin and the Long Beach Hilton and had granted licenses to operate two Daily Grill restaurants (at LAX and the North Shore Skokie Hotel in Skokie, Illinois).

Under the terms of our management agreements, we are responsible for all aspects of the restaurant's operation for which we earn a fee, however, we have no ownership in the restaurant. Restaurant management services include overseeing the design, development, construction, equipping, furnishing and operation of the restaurant. Once the restaurant is open to the public, the manager is responsible for rendering and performing all services in connection with the operation of the restaurant. Those services include employing, training and supervising personnel, and purchasing and maintaining adequate inventory, etc. We are liable for all debts and obligations that we incur on behalf of the managed outlets including payroll and related costs of the restaurant staff who are our employees. All such costs are included as reimbursed costs in our consolidated statements of operations and we also record revenue for those costs that are reimbursed by the restaurants as cost reimbursements.

Each management agreement is individually negotiated and may include an investment on our part, a management fee and a profit sharing interest. For restaurants under management at December 31, 2006, we had made investments ranging from \$0 to \$500,000, are entitled to management fees ranging from 5% to 8.5% of gross revenues and entitled to 25% to 35% of annual restaurant profits.

Under restaurant licensing agreements, we earn a licensing fee in exchange for use of our brand, as well as, the proprietary menu. Under the terms of our license agreements, licensees are generally responsible for all costs of construction and operation of the licensed restaurant and we receive license fees ranging from 2% to 4% of restaurant revenues subject to varying sales thresholds or minimum license fees negotiated with respect to each licensed restaurant.

Hotel Property Agreement

In order to facilitate our efforts to open restaurants on a large scale basis in hotel properties, in August of 1998, we entered into the Hotel Property Agreement (the "HRP Agreement") with Hotel Restaurant Properties, Inc. ("HRP") pursuant to which HRP agreed to assist us in locating

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suitable hotel locations for the opening of our restaurants. At the time the HRP Agreement was entered, HRP was considered a related party as one of its owners is a family member of a director and preferred stock holder. In May 1999 the HRP Agreement was amended under the same terms and conditions except that it became 100% owned by the family member. HRP was responsible for identifying suitable hotel locations in which a Grill or Daily Grill could be operated (Managed Outlets) and negotiating and entering into leases or management agreements for those properties. We, in turn, would enter into management agreements with HRP or the hotel owners, as appropriate. We would, in some instances, advance certain pre-opening costs and certain required advances (Manager Loans) and would manage and supervise the day-to-day operations of each Managed Outlet. From the gross management fee, we were entitled to receive a base overhead fee equal to \$1,667 per month per Managed Outlet. The remaining fee income, less any expenses and after repayments required on Manager Loans from each Managed Outlet, were allocated 75% to us and 25% to HRP.

In July 2001, in conjunction with an investment in the Company by Starwood Hotels, the HRP Agreement was amended to limit, for so long as we were subject to the exclusivity provisions of a Property Development Agreement with Starwood, the amounts payable to HRP to \$400,000 annually plus 12.5% of the amounts otherwise payable to HRP with respect to the Burbank, Georgetown and San Jose Hilton restaurants.

The operating agreement with HRP contained a clause whereby, HRP had the right to cause us to purchase HRP (the put option) at any time in the event of a change in control or after May 2004 subject to certain conditions and we had the right to purchase HRP (the call option) after May 2004 subject to certain conditions.

Under the respective put and call options, the purchase price (APP) (principally paid in stock) of HRP would be 25% multiplied by 10 (Multiple) times the operating income of HRP (gross receipts for the prior twelve months less operating expenses which are averaged over a five year period), with certain allowed exclusions from operating income minus the principal balance of any outstanding loans (with certain allowed exclusions) to HRP. Under the put option the multiple may change if 87.5% multiplied by the closing price of our common stock divided by EBITDA per share was less than 10. If we sold assets or stock to certain third parties introduced by HRP which caused a change in control, then the Purchase Price would be the greater of: (A) \$3,000,000 or (B) the APP, not to exceed \$4,500,000.

On September 1, 2006, we entered into an Agreement for Purchase and Sale of Assets (the HRP Purchase Agreement) with HRP and certain affiliates (collectively, the HRP Sellers).

Pursuant to the terms of the HRP Purchase Agreement, the HRP Sellers agreed to sell to us and we agreed to purchase from the HRP Sellers certain rights and interests of the HRP Sellers relating to the current and future operation of GCI restaurants in hotel properties pursuant to the terms of the HRP Agreement. At the date of the HRP Purchase Agreement, we operated 7 restaurants subject to the HRP Agreement in San Francisco, California; Houston, Texas; Washington D.C.; Portland, Oregon; Burbank, California; Skokie, Illinois; and Long Beach, California.

Under the HRP Purchase Agreement, the HRP Sellers agreed to transfer to us all of the rights in the management agreements (the Transferred Agreements) relating to the San Francisco; Houston; Washington, D.C.; and Portland restaurants as well as ownership of the Houston liquor license.

Pursuant to the HRP Purchase Agreement, the HRP Agreement was amended, effective June 30, 2006 (the HRP Sale Eff