GRILL CONCEPTS INC
Form 10-K
April 04, 2006

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

(MARK ONE)
[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Fiscal Year Ended December 25, 2005

[ ] 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. 0-23226

GRILL CONCEPTS, INC.

(Exact name of registrant as specified in its charter)

Delaware	13-3319172
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

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:

Title of Each Class	Name of Each Exchange on Which Registered
None	None

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

Common Stock, $.00004 par value

(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 [X]

Indicate by check marked if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes [ ] No [X]

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 [X] 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 [X]

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

Yes [ ] No [X]

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 Small-Cap Market, as of the close of business June 30, 2005 was approximately $15,834,000.

Number of shares outstanding of the registrant's common stock, $.00004 par value, as of March 10, 2006: 5,768,195 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 25, 2005 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 the section entitled "Certain Factors Affecting Future Operating Results" beginning on page 37 of this Form 10-K.

ITEM 1. BUSINESS

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

GENERAL

Grill Concepts, Inc. and its subsidiaries (the "Company") develops, owns, operates, manages and licenses 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 ("GCI"), in March of 1995, we have focused principally on the expansion of the "Daily Grill" and "The Grill on the Alley" restaurant formats of GCI.

At December 25, 2005, we owned and operated sixteen restaurants and managed or licensed eight additional restaurants. Twelve Daily Grill restaurants and four The Grill on the Alley restaurants are owned and operated, six Daily Grill restaurants are managed and we license two Daily Grill restaurants. With the exception of three The Grill on the Alley restaurants, and three 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 25, 2005, 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.

During 2005, 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 The Grill on the Alley restaurants in hotel properties, and non-hotel based restaurants, in strategic markets throughout the United States.

During 2005, we opened two restaurants consisting of (1) a 100% owned Daily Grill, opened in March 2005 in Santa Monica, California and (2) a joint venture Daily Grill restaurant, opened in May 2005 in downtown Los Angeles, California. On July 31, 2005 the La Cienega Daily Grill in Los Angeles, California was closed when the lease expired.

In February 2006, we began construction of a 100% owned Grill on the Alley at the Galleria shopping center in Dallas, Texas. The restaurant is expected to open in the summer of 2006.

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

	2005	2004
Number of restaurants:		
Daily Grill restaurants:		
Company Restaurants:		
Beginning of year	11	10
Restaurant opening	2	1
Restaurant closings	(1)	-
End of year	12	11
Managed or Licensed Restaurants:		
Beginning of year	8	7
Restaurant openings	-	1
End of year	8	8
Total Daily Grill restaurants:		
Beginning of year	19	17
Restaurant openings	2	2
Restaurants closed or sold	(1)	-
End of year	20	19
Grill restaurants:		
Company Restaurants:		
Beginning of year	4	4
Restaurant openings	-	-
End of year	4	4
Total Grill restaurants:		
Beginning of year	4	4
Restaurant openings	-	-
End of year	4	4
Other restaurants:		
Managed or Licensed Restaurants:		
Beginning of year	-	1
Restaurant closings	-	(1)

End of year	-	-
Total Other restaurants:		
Beginning of year	-	1
Restaurants closed or sold	-	(1)
End of year	-	-
Total restaurants:		
Beginning of year	23	22
Restaurant openings	2	2
Restaurants closed or sold	(1)	(1)
End of year	24	23

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The following table sets forth unaudited per restaurant sales information, comparable restaurant sales information for restaurants open twelve months in both periods, and total sales information during 2005 and 2004 by restaurant concept for owned restaurants ("Company Restaurants"):

	2005	2004
Weighted average weekly sales per restaurant:		
Daily Grill restaurants:		
Company Restaurants	$ 59,456	$ 57,757
Grill restaurants:		
Company Restaurants	$ 85,110	$ 77,545
Change in comparable restaurant sales:		
Daily Grill restaurants		
Company Restaurants	1.1%	4.6%
Grill restaurants		
Company Restaurants	9.8%	2.1%
Total sales:		
Daily Grill	$37,003,000	$33,809,000
Grill	17,703,000	16,129,000
Total consolidated sales	$54,706,000	$49,938,000

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 which is reported as management and license fee revenue. The gross sales of managed and licensed restaurants are not included in our 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 Grill Concepts-branded restaurants, categorized as, managed and licensed restaurants were as follows:

	2005	2004
Gross Sales		
Managed Daily Grills	$19,242,000	$16,382,000
Licensed Daily Grills	7,852,000	8,003,000
	$27,094,000	$24,345,000
Management and license fees	$ 1,683,000	$ 1,282,000
Percent of gross sales	6.2%	5.3%

OPERATING PRINCIPLES

All Grill Concepts' 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 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 65% per year for all employees, considerably below the industry average which management believes to be approximately 111%.

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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 seven cooks and each Grill has up to eight 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.

RESTANT CONCEPTS

- DAILY GRILL RESTAURANTS

Background. At December 25, 2005, we, through our subsidiaries, owned and operated, managed or licensed twenty Daily Grill restaurants principally in Southern California, and the Washington, D.C./Virginia market. 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 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 (Hilton Hotel)	January 1999	Managed
Washington, D.C. (Georgetown Inn)	April 1999	Managed
Universal CityWalk, California	May 1999	50%
Skokie, Illinois (DoubleTree 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%

Each 100% owned Daily Grill restaurant is located in leased facilities.

Site selection is viewed as critical to the success of our restaurants and, accordingly, significant effort is exerted to assure that each site selected is appropriate. For non-hotel based restaurants, the site selection process focuses on local demographics and household income levels, as well as specific site characteristics such as visibility, accessibility, parking availability and traffic volume. Each site must have sufficient traffic such that management believes the site can support at least twelve strong meal periods a week (i.e., five lunches and seven dinners). Preferred Daily Grill sites, which characterize the existing 100% owned restaurants, are high-end, mid-size retail shopping malls in large residential areas with significant daytime office populations and some entertainment facilities. Historically, Daily Grill restaurants have been viewed as desirable tenants drawing traffic to the high profile malls where we locate and, therefore, have received significant tenant improvement allowances.

Hotel based Daily Grill restaurants may be newly constructed facilities or remodeled facilities on the premises of, or adjacent to, a hotel. Such facilities may be leased, operated pursuant to a partnership, a joint venture, a license arrangement, or a management agreement. As with non-hotel based restaurants, site selection is viewed as critical and, accordingly, significant effort is exerted to assure that each site selected is appropriate. In 1998 we entered into an agreement with Hotel Restaurant Properties, Inc. ("HRP") under which they assist us in finding suitable hotel based locations and may negotiate leases, license or management agreements for those properties. See "-- Hotel Property Agreement" and " Certain Relationships and Related Transactions".

Existing non-hotel based Daily Grill restaurants range in size from 3,750 to 7,000 square feet of which approximately 30% is devoted to kitchen and service areas and seat between 100 and 250 persons. Our costs for existing non-hotel based restaurants, including leasehold improvements, furniture, fixtures and equipment and pre-opening expenses, have averaged $325 per foot per restaurant, less tenant improvement allowances.

Existing hotel based Daily Grill restaurants range in size from 5,000 to 8,000 square feet of which approximately 30% is devoted to kitchen and service areas and seat between 140 and 252 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 T-bone steak with all the trimmings. The average lunch check is $16.00 per person and the average dinner check is $25.00 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 25, 2005, 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. 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

Background. At December 25, 2005, we, through our subsidiary, GCI, owned and operated four 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.

Restaurant Sites. At December 25, 2005, we operated four Grill restaurants, two 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 or managed as indicated and, where indicated, in the referenced hotels:

Location	Opened	Ownership Interest or Managed
Beverly Hills, California	January 1984	100.00%
San Jose, California (Fairmont Hotel)	May 1998	50.05%
Chicago, Illinois (Westin Hotel)	June 2000	60.00%
Hollywood, California	November 2001	51.00%
Dallas, Texas	Summer 2006	100.00%

Our Grill restaurants are located in leased facilities. As with the Daily Grill restaurants, site selection is viewed as critical to success and, accordingly, significant effort is exerted to assure that each site selected is appropriate. For non-hotel based Grill restaurants, the site selection process focuses on local demographics and household income levels, as well as specific site characteristics such as visibility, accessibility, parking availability and traffic volume. Because of the upscale nature of Grill restaurants, convenience for business patrons is considered a key site selection criterion.

Hotel based Grill restaurants may be newly constructed facilities or remodeled facilities on the premises of, or adjacent to, a hotel. Such facilities may be leased by us, or operated pursuant to a partnership or joint venture arrangement. As with non-hotel based restaurants, site selection is viewed as critical to success and, accordingly, significant effort is exerted to assure that each site selected is appropriate.

Existing non-hotel based Grill restaurants range in size from approximately 4,300 to 5,600 square feet of which approximately 35% is devoted to kitchen and service areas and seat 120 to 200 guests.

Existing hotel based Grill restaurants range in size from approximately 8,000 to 8,500 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 $3.1 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.

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Entrees range in price from $13.25 for a cheeseburger to $39.75 for a prime porterhouse steak. The average lunch check is $25.00 per person and the average dinner check is $50.00 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 25, 2005, food and non-alcoholic beverage sales constituted approximately 71% of the total restaurant revenues for Grill restaurants, with alcoholic beverages accounting for the remaining 29%.

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.

RESTAURANT MANAGEMENT AND LICENSING ACTIVITIES

In addition to owning and operating Daily Grills and The Grills, we, at December 25, 2005, provided contract management services for six hotel based Daily Grill restaurants at the Burbank Hilton, 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 DoubleTree 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 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 25, 2005, we had made investments ranging from $0 to $500,000, are entitled to management fees, along with HRP, ranging from 5% to 8.5% of gross revenues and entitled, along with HRP, 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 with Hotel Restaurant Properties, Inc. ("HRP") pursuant to which HRP agreed to assist us in locating suitable hotel locations for the opening of our restaurants. HRP is 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 is now 100% owned by the family member. HRP is responsible for identifying suitable hotel locations in which a Grill or Daily Grill can be operated ("Managed Outlets") and negotiating and entering into leases or management agreements for those properties. We, in turn, enter into management agreements with HRP or the hotel owners, as appropriate. We may advance certain pre-opening costs and certain required advances ("Manager Loans") and will manage and supervise the day-to-day operations of each Managed Outlet. From the gross management fee, we are 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, are allocated 75% to us and 25% to HRP.

In July 2001, in conjunction with an investment in the Company by Starwood Hotels, the Hotel Property Agreement was amended to limit, for so long as we are 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 contains a clause whereby, HRP has the right to cause us to purchase HRP (the put option) at any time there is a change in control or after May 2004 subject to certain conditions and we have 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 will 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 is less than 10. If we sell assets or stock to certain third parties introduced by HRP which causes a change in control, then purchase price will be the greater of: (A) $3,000,000 or (B) the APP, not to exceed $4,500,000.

BUSINESS EXPANSION

Our expansion plans focus on the addition of Daily Grill restaurants with selected expansion of the Grill restaurant concept also planned.

Management continually reviews possible expansion into new markets and within existing markets. Such reviews entail careful analysis of potential locations to assure that the demographic make-up and general setting of new restaurants is consistent with the patterns which have proven successful at the existing Daily Grills and Grills. While the general appearance and operations of future Daily Grills and Grill restaurants are expected to conform generally to those of existing facilities, we intend to monitor the results of any modifications to our existing restaurants and to incorporate any successful modifications into future restaurants. All future restaurants are expected to feature full bar service.

Our future expansion efforts are expected to concentrate on expansion into new and existing markets through a combination of Company owned restaurants and hotel based restaurants pursuant to the Hotel Property Agreement. With the assistance of HRP, we expect to establish name recognition and market presence through the opening of Daily Grill and Grill restaurants in fine hotel properties in strategic markets throughout the United States. Upon establishing name recognition and a market presence in a market, we intend to construct and operate clusters of restaurants within those markets. Management intends to limit the construction and operation of Grill restaurants to one restaurant per market while constructing multiple Daily Grill restaurants within each market. The exact number of Daily Grill restaurants to be constructed within any market will vary depending upon population, demographics and other factors.

Our primary operating markets during 2005 were restaurants in Southern California, principally the greater-Los Angeles market, and metropolitan Washington, D.C. During 2005, we opened two non-hotel based Daily Grill restaurants one in Santa Monica, California in March 2005 and one in downtown Los Angeles, California in May 2005. We also closed our La Cienega Daily Grill in July 2005 on expiration of the restaurant lease. At December 25, 2005, we had entered into a lease covering a Grill restaurant that is expected to open in the Summer of 2006 in the Galleria shopping center in Dallas, Texas. Management is presently evaluating the opening of additional non-hotel based Daily Grill and Grill restaurants in existing markets and in other major metropolitan areas. Existing markets will be evaluated for expansion in order to establish market presence and economies of scale. As of March 2006, conversations are on-going for a number of sites, in addition to the Dallas, Texas location, but no agreements have been signed. Management anticipates that the cost to open additional Daily Grill and Grill restaurants will average $325 to $375 per square foot per restaurant, less tenant improvement allowances, with each restaurant expected to be approximately 6,000 to 7,000 square feet in size. Actual costs may vary significantly depending upon the tenant improvements, market conditions, rental rates, labor costs and other economic factors prevailing in each market in which we pursue expansion.

We are presently evaluating the opening of additional hotel based Daily Grill restaurants in existing markets and in other major metropolitan areas. Each hotel restaurant arrangement will be negotiated separately and the size of the restaurants, ownership and operating arrangements and capital investment on our part may vary widely.

STARWOOD DEVELOPMENT AGREEMENT

On July 27, 2001, in conjunction with the purchase by Starwood Hotels and Resorts of 666,667 shares of our common stock and 666,667 $2.00 warrants for $1,000,000, we and Starwood entered into a Development Agreement under which we and Starwood agreed to jointly develop our restaurant properties in Starwood hotels.

Under the Starwood Development Agreement, either we, or Starwood, may propose to develop a Daily Grill, Grill or City Bar and Grill restaurant in a Starwood hotel property. If the parties agree in principal to the development of a restaurant, the parties will attempt to negotiate either a management agreement or a license agreement with respect to the operation of the restaurant.

So long as Starwood continues to meet certain development thresholds set forth in the Development Agreement, we are prohibited from developing, managing, operating or licensing our restaurants in any hotel owned, managed or franchised by a person or entity, other than Starwood, with more than 50 locations operated under a single brand. Existing hotel based restaurants are excluded from the exclusive right of Starwood. The development thresholds required to be satisfied to maintain Starwood's exclusive development rights require, generally, (1) the signing of an average of one management agreement or license agreement with respect to Daily Grill restaurants annually over the life of the Development Agreement, (2) the signing of one management agreement or license agreement in any two year period with respect to Grill restaurants, and (3) the signing of an aggregate average of three management agreements or license agreements with respect to all of our restaurants annually over the life of the Development Agreement. Satisfaction of the thresholds set forth in the Development Agreement are determined on each anniversary of the Development Agreement. With respect to satisfaction of the specific thresholds applying to Daily Grill restaurants and Grill restaurants, the failure to satisfy the development thresholds with respect to those individual brands will terminate the exclusivity provisions relative to such brand but will not affect the exclusivity rights as to the other brand or in general.

Under the Development Agreement, we are obligated to issue to Starwood warrants to acquire a number of shares of our common stock equal to four percent of the outstanding shares upon the attainment of certain development milestones. Such warrants are issuable upon execution of management agreements and/or license agreements relating to the development and operation, and the commencement of operation, of an aggregate of five, ten, fifteen and twenty of our branded restaurants. If the market price of our common stock on the date the warrants are to be issued is greater than the market price on the date of the Development Agreement, the warrants will be exercisable at a price equal to the greater of (1) 75% of the market price as of the date such warrant becomes issuable, or (2) the market price on the date of the Development Agreement. If the market price of our common stock on the date the warrants are to be issued is less than the market price on the date of the Development Agreement, the warrants will be exercisable at a price equal to the market price as of the date such warrants become issuable. The warrants will be exercisable for a period of five years.

In addition to the warrants described above, if and when the aggregate number of restaurants operated under the Development Agreement exceeds 35% of the total Daily Grill, Grill and City Grill-branded restaurants, we will be obligated to issue to Starwood a warrant to purchase a number of shares of our common stock equal to 0.75% of the outstanding shares on that date exercisable for a period of five years at a price equal to the market price at that date. On each anniversary of that date on which the restaurants operated under the Development Agreement continues to exceed the 35% threshold, for so long as the Development Agreement remains effective, we shall issue to Starwood additional warrants to purchase 0.75% of the outstanding shares on that date at an exercise price equal to the market price on that date.

Following the events of September 11, 2001, Starwood substantially curtailed new development activities and only two management agreements have, as yet, been entered into under the Development Agreement. The exclusivity agreement has terminated due to the lack of performance on Starwood's part.

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. Restaurant operations are standardized, and a comprehensive management manual exists to ensure operational quality and consistency.

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. With the current systems, revenue and cost reports, including food and labor 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 six-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 bi-weekly 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 ten 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. Experienced servers 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 which 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 which prepares the bread according to a proprietary recipe and delivers 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 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 Senior Vice President - Culinary establishes general purchasing policies and is responsible for controlling the price and quality of all ingredients. The Senior Vice President - Culinary in conjunction with our team of chefs, constantly monitors 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.

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 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 2005, expenditures for advertising and promotion were approximately 1.0% of total revenues.

COMPETITION

The Daily Grill restaurants compete within the full-service upscale casual dining segment. Daily Grill competitors include national and regional chains, such as Cheesecake Factory and Houston's, as well as local owner-operated restaurants. Grill restaurants compete within the fine dining segment. Grill competitors include a limited number of national fine dining chains as well as selected local owner-operated fine dining establishments. Competition for our hotel-based restaurants is primarily limited to restaurants within the immediate proximity of the hotels.

The restaurant business is highly competitive with respect to price, service, restaurant location and food quality and is affected by changes in consumer tastes, economic conditions and population and traffic patterns. We believe we compete favorably with respect to these factors. We believe that our ability to compete effectively will continue to depend in large measure on our ability to offer a diverse selection of high quality, fresh food products with an attractive price/value relationship served in a friendly atmosphere.

EMPLOYEES

We, and our subsidiaries, employ approximately 1,656 people, 31 of whom are home office personnel and 149 of whom are restaurant managers, assistant managers and chefs. The remaining employees are restaurant personnel. Of our employees, approximately 68% are full-time employees, with the remainder being part-time employees.

Management believes that its employee relations are good at the present time. An anonymous employee survey is taken each year and the results are disseminated to keep home office and restaurant management aware of the level of employee satisfaction.

With the exception of the Chicago Grill on the Alley, none of our employees are represented by labor unions or are subject to collective bargaining or other similar agreements. The union contract expired in August 2005 and has been verbally agreed to for an additional three-year term. Management believes that its employee relations are good at the present time.

TRADEMARKS AND SERVICE MARKS

We regard our trademarks and service marks as having significant value and as being important to our marketing efforts. We have registered our "Daily Grill" mark and "The Grill on the Alley" and "Think Daily" marks and logos. As well as other marks with the United States Patent and Trademark Office as

service marks for restaurant service. Our "The Grill on the Alley" mark and logo is also secured in California. Our policy is to pursue registration of our marks and to oppose strenuously any infringement.

GOVERNMENT REGULATION

We are subject to various federal, state and local laws affecting our business. Each of our restaurants is subject to licensing and regulation by a number of governmental authorities, which may include alcoholic beverage control, health and safety, and fire agencies in the state or municipality in which the restaurants are located. Difficulties or failures in obtaining or renewing the required licenses or approvals could result in temporary or permanent closure of our restaurants.

Alcoholic beverage control regulations require each of our restaurants to apply to a state authority and, in certain locations, county and municipal authorities for a license or permit to sell alcoholic beverages on the premises. Typically, licenses must be renewed annually and may be revoked or suspended for cause at any time. Alcoholic beverage control regulations relate to numerous aspects of the daily operation of our restaurants, including minimum age of patrons and employees, hours of operation, advertising, wholesale purchasing, inventory control, and handling, storage and dispensing of alcoholic beverages.

We may be subject in certain states to "dram-shop" statutes, which generally provide a person injured by an intoxicated person the right to recover damages from an establishment which served alcoholic beverages to such person. In addition to potential liability under "dram-shop" statutes, a number of states recognize a common-law negligence action against persons or establishments which serve alcoholic beverages where injuries are sustained by a third party as a result of the conduct of an intoxicated person. We presently carry liquor liability coverage as part of our existing comprehensive general liability insurance.

Various federal and state labor laws govern our relationship with our employees, including such matters as minimum wage requirements, overtime and other working conditions. Significant additional government-imposed increases in minimum wages, paid leaves of absence and mandated health benefits, or increased tax reporting requirements for employees who receive gratuities, could be detrimental to the economic viability of our restaurants. Management is not aware of any environmental regulations that have had a material effect on us to date.

EXECUTIVE OFFICERS

Our executive officers as of December 25, 2005, and their ages and positions as of that date, are as follows:

Name	Age	Position
Robert Spivak	62	President and Chief Executive Officer
Michael Weinstock	63	Chairman of the Board and Executive Vice President
John Sola	53	Vice President - Operations and Development
Philip Gay	48	Executive Vice President and Chief Financial Officer

ROBERT SPIVAK has served as our President, Chief Executive Officer and a director since 1995. Mr. Spivak was a co-founder of our predecessor, Grill Concepts, Inc. (a California corporation)("GCI") and served as President, Chief Executive Officer and a director of GCI from the company's inception in 1988 until 1995. Prior to forming GCI, Mr. Spivak co-founded, and operated, The Grill on the Alley restaurant in Beverly Hills in 1984. Mr. Spivak is a founder and past president of the Beverly Hills Restaurant Association. Mr. Spivak also chairs the executive advisory board of the Collins School of Hotel and

Restaurant Management at California State Polytechnic University at Pomona, is Director Emeritus of the California Restaurant Association and is a member of the Board of Directors of DiRoNA - Distinguished Restaurants of North America.

MICHAEL WEINSTOCK has served as our Executive Vice President and a director since 1995 and as Chairman of the Board since 2000. From 1995 to 2000, Mr. Weinstock served as Vice-Chairman of the Board. Mr. Weinstock was a co-founder of GCI and served as Chairman of the Board, Vice President and a director of GCI from 1988 until 1995. Prior to forming GCI, Mr. Weinstock co-founded The Grill on the Alley restaurant in Beverly Hills in 1984. Mr. Weinstock previously

served as President, Chief Executive Officer and a director of Morse Security Group, Inc., a security systems manufacturer.

JOHN SOLA has served as our Vice President - Operations and Development since September 2001. Previously, Mr. Sola served as Executive Chef for GCI from 1988 until 1995 when he assumed the position of Vice President - Executive Chef of the Company. Mr. Sola oversees all kitchen operations, including personnel, food preparation and food costs, as well as monitoring and maintaining the overall performance of the kitchens and establishing procedures and policies in connection with the opening of new Daily Grill restaurants. Mr. Sola, along with Mr. Spivak, created the Daily Grill menu. Prior to joining GCI, Mr. Sola served as opening chef at The Grill on the Alley from inception in 1984 to 1988. Previously, Mr. Sola served in various positions, including Executive Chef, at a wide range of restaurants.

PHILIP GAY has served as our Executive Vice President and Chief Financial Officer since July 2004. From March 2000 until he joined Grill Concepts in July 2004, Mr. Gay served as Managing Director of Triple Enterprises, a business advisory firm that assisted mid-cap sized companies with financing, mergers and acquisitions, franchising and strategic planning. From March 2000 to November 2001, Mr. Gay served as an independent consultant with El Paso Energy. Previously he has served as Chief Financial Officer for California Pizza Kitchen (1987 to 1994), Chief Financial Officer and Interim Chief Executive Officer for Wolfgang Puck Food Company (1994 to 1996), Chief Executive Officer for Color Me Mine and has held various Chief Operating Officer and Chief Executive Officer positions with Diversified Food Group from 1996 to 2000. Mr. Gay is also on the financial advisory board for Concours Consulting and is on the Board of Motor Car Parts of America, a publicly traded company that remanufactures starters and alternators. He is a Certified Public Accountant, a former audit manager at Laventhol and Horwath and a graduate of the London School of Economics.

There are no family relationships among the executive officers and directors. Except as otherwise provided in employment agreements, each of the executive officers serves at the discretion of the Board.

Mr. Spivak has announced his planned retirement effective June 2006 at which time Mr. Gay is to assume the positions of President and Chief Executive Officer.

ITEM 1A. RISK FACTORS

The following are certain risk factors that could affect our business, financial results and results of operations. These risk factors should be considered in connection with evaluating the forward-looking statements contained in this Annual Report on Form 10-K because these factors could cause the actual results and conditions to differ materially from those projected in forward-looking statements. Before you buy our common stock, you should know that making such an investment involves some risks, including the risks described below. The risks that we have highlighted here are not the only ones that we face. If any of the risks actually occur, our business, financial condition or results of operations could be negatively affected. In that case, the trading price of our stock could decline, and you may lose all or part of your investment.

OUR FUTURE GROWTH AND EXPANSION ARE DEPENDENT UPON OUR ABILITY TO OPEN ADDITIONAL RESTAURANTS AND OPERATE NEW RESTAURANTS PROFITABLY.

Future growth in sales and profits will depend to a substantial extent on our ability to increase the number of restaurants we operate, license or manage. Our ability to open additional restaurants will depend upon a number of factors, including the availability of suitable locations, our ability to negotiate leases on acceptable terms, the securing of required governmental permits and approvals, the hiring and training of skilled restaurant management and hourly employees, the availability of financing on acceptable terms (if at all), general economic conditions and other factors, many of which are beyond our control. Due to the highly customized nature of our restaurant concept and the complex design, construction, and pre-opening processes for each new location, the lease negotiation and restaurant development timeframes vary from location to location and can be subject to unforeseen delays. There can be no assurance that we will be able to open new restaurants or that, if opened, those restaurants will be operated profitably.

OUR RELATIVE SMALL SIZE MAKES US VULNERABLE TO RISKS ASSOCIATED WITH LACK OF DIVERSIFICATION AND RISKS ASSOCIATED WITH MANAGING AND SUPPORTING GROWING OPERATIONS.

We operated 22 restaurants at December 31, 2005. Due to this relatively small number of restaurants, poor operations at any one restaurant could materially affect our overall profitability. Even though our revenues have grown over the last decade, our current restaurant field supervision and corporate support infrastructures remain relatively small. Accordingly, we remain vulnerable to a variety of business risks generally associated with smaller, growing companies. Any failure to continue to upgrade operating, financial, and restaurant support systems or unexpected difficulties encountered during expansion could adversely affect our business, financial condition, and results of operations. Although we believe that our systems and controls are adequate to address our current needs and we are in the process of upgrading certain of our operating and financial systems and processes, there can be no assurance that such upgraded systems and processes will be adequate to sustain future growth, and that further upgrades will not be necessary.

OUR PROFITABILITY IS SUBJECT TO RISKS ASSOCIATED WITH FLUCTUATIONS IN COSTS OF KEY INGREDIENTS, LABOR AND UTILITIES.

Our profitability is dependent upon our ability to anticipate and react to changes in the costs of key operating resources, including food and other raw materials, labor, utilities and other supplies and services. Various factors beyond our control, including adverse weather and general marketplace conditions, may affect the availability and cost of food and other raw materials. Recent increases in energy costs may have a material adverse impact on our restaurant profitability if those costs continue at current, or higher, levels. The impact of inflation on food, labor and occupancy costs can significantly affect our operations. While management has been able to react to inflation and other changes in the costs of key operating resources by increasing prices for menu items, there can be no assurance that we will be able to continue to do so in the future. There can also be no assurance that we will continue to generate increases in comparable restaurant sales in amounts sufficient to offset inflationary or other cost pressures.

OUR SUCCESS IS DEPENDENT UPON OUR ABILITY TO RETAIN THE SERVICES OF KEY SENIOR MANAGEMENT PERSONNEL AND ATTRACT AND RETAIN ADDITIONAL KEY PERSONNEL.

The success of our business is highly dependent upon the services of our senior executive team. Robert Spivak, our co-founder and President and Chief Executive Officer has announced his pending retirement. In conjunction with Mr. Spivak's pending retirement, Philip Gay, our current Executive Vice President and Chief Financial Officer is to be promoted to the position of President and Chief Executive Officer and a new Chief Financial Officer is to be named. Mr. Spivak has agreed to continue providing services as a part time consultant following his retirement. Our success will be dependent, during the period immediately following Mr. Spivak's retirement, upon our ability to successfully transition our senior management team under the leadership of Mr. Gay and a new Chief Financial Officer. Further, our success will be dependent upon the continued services of our senior management team and our ability to attract and retain skilled management employees at all levels of operations. Poor execution in our transition of senior management personnel or the loss of services of key personnel could have a material adverse effect upon our business.

OUR OPERATIONS ARE SUBJECT TO INTENSE COMPETITION AND CHANGES IN CONSUMER PREFERENCES.

The restaurant industry is highly competitive. There are a substantial number of restaurant operations that compete directly and indirectly with us, some of which may have significantly greater financial resources, higher revenues, and greater economies of scale than we enjoy. The restaurant business is often affected by changes in consumer tastes and discretionary spending patterns, national and regional economic conditions, demographic trends, consumer confidence in the economy, traffic patterns, the cost and availability of raw materials and labor, purchasing power, governmental regulations and local competitive factors. Any change in these factors could adversely affect our restaurant operations. Multi-unit foodservice operations such as ours can also be substantially affected by adverse publicity resulting from food quality, illness, injury, health concerns, or operating issues stemming from a single restaurant. We attempt to manage these factors, but the occurrence of any one of these factors could cause our business to be adversely affected. We believe that our restaurants compete favorably in the consumer marketplace with respect to the attributes of quality, variety, taste, service, consistency, and overall value.

OUR BUSINESS IS SUBJECT TO SEASONAL FLUCTUATIONS THAT MAY ADVERSELY AFFECT OUR QUARTERLY OPERATING RESULTS IN SELECT PERIODS.

Our business is subject to seasonal fluctuations. Historically, our highest earnings have occurred in the first and fourth quarters of the fiscal year, as our sales in most of our restaurants have typically been higher during the first

and fourth quarters of the fiscal year. As a result of these factors, results of operations for any single quarter are not necessarily indicative of the results that may be achieved for a full fiscal year. Quarterly results have been, and in the future will continue to be, significantly impacted by the timing of new restaurant openings and their respective pre-opening costs.

OUR CALIFORNIA BASED RESTAURANTS HAVE IN THE PAST BEEN, AND MAY IN THE FUTURE BE, SUBJECT TO TEMPORARY CLOSURE DUE TO ENERGY SHORTAGES.

High energy costs and consumption and constrained energy supplies have periodically resulted in rolling blackouts in California, particularly during summer months. We have experienced periodic temporary restaurant closures in the past as a result of such rolling blackouts and may experience similar closures in the future. Any such closures will result in loss of revenues from the effected restaurants and potentially higher occupancy and operating costs.

OUR BUSINESS IS SUBJECT TO EXTENSIVE GOVERNMENT REGULATIONS THAT MAY ADVERSELY AFFECT OUR EXISTING OR PLANNED OPERATIONS OR RESULT IN ADDITIONAL COSTS OR POTENTIAL LIABILITIES.

Our business is subject to extensive state and local government regulation in the various jurisdictions in which our restaurants are located, including regulations relating to alcoholic beverage control, public health and safety and fire codes. The failure to obtain or retain food and liquor licenses could adversely affect the operation of our restaurants. Any difficulties, delays or failures in obtaining and/or retaining licenses, permits or other regulatory approvals could delay or prevent the opening and/or continued operation of a restaurant in a particular area. We may also be subject to "dram shop" statutes in certain states which generally provide a person injured by an intoxicated person the right to recover damages from an establishment that wrongfully served alcoholic beverages to the intoxicated person.

We are subject to the Fair Labor Standards Act, which governs such matters as minimum wages, overtime and other working conditions, along with the Americans With Disabilities Act, various family leave mandates and a variety of other laws enacted, or rules and regulations promulgated, by federal, state and local governmental authorities that govern these and other employment matters. We expect increases in payroll expenses as a result of federal, state and local mandated increases in the minimum wage, and although such increases are not expected to be material, we cannot assure that there will not be material increases in the future. In addition, our vendors may be affected by higher minimum wage standards, which may increase the price of goods and services supplied to us.

WE ARE SUBJECT TO PENDING LITIGATION, AND POTENTIAL LIABILITY, REGARDING APPLICATION OF EMPLOYMENT REGULATIONS.

Complex issues relating to the interpretation and application of various labor regulations may result in our incurring unforeseen costs and/or liabilities relating to compliance with such regulations. Many restaurant operators in California have been subject to litigation over the last year relating to non-compliance with California labor provisions mandating that employees be provided meal and break periods. A former employee has filed a class action lawsuit against us asserting violation of the applicable California regulations regarding meal and break periods. While we believe that all of our employees were provided with the opportunity to take all required meal and rest breaks, many restaurant operators in California have incurred substantial expenses in settling similar claims and we may incur substantial expenses in connection with defending or settling the pending litigation.

A Class Action complaint was filed in the Superior Court of the State of California for the County of Los Angeles on March 15, 2006. The plaintiff and those similarly situated (Servers) complain that the company has violated the labor code by having Servers "Tip Out" Bartenders and Expeditors a percentage of their tips to these employees who provide no direct table service. The complaint has labeled this act as "Tip-pooling." The company has not yet been served with this complaint.

WE MAY BE SUBJECT TO INCREASED LIABILITY RESULTING FROM OUR PARTIAL SELF-INSURANCE OF WORKERS COMPENSATION CLAIMS.

In order to better manage the cost of our workers compensation expense, commencing in 2004, we altered our workers compensation coverage to substantially increase our per event and aggregate deductibles. As a result, we expect to reduce our recurring cost of workers compensation insurance but are

exposed to substantially higher potential losses that could result from claims under that policy should those claims exceed our prior deductible levels.

WE MAY EXPERIENCE INCREASED COSTS, WORKER RELATED IMPEDIMENTS AND OTHER LOSSES AT OUR CHICAGO RESTAURANT AS A RESULT OF OUR USE OF UNION WORKERS.

The employees of our Chicago restaurant are members of the Hotel Employees and Restaurant Employees Union, Local 1, AFL-CIO. As a result of our Chicago workforce being unionized, we experience higher labor costs in our Chicago operations, have less managerial control over our workforce and are subject to certain impediments, delays, costs and other potential risks not faced at our other restaurants. Accordingly, we may experience unexpected losses or costs in our Chicago operations.

PROVISIONS IN OUR CHARTER AND IN DELAWARE LAW MAY IMPEDE, DELAY OR PREVENT POTENTIAL TAKEOVERS THAT MIGHT OTHERWISE BE BENEFICIAL TO OUR STOCKHOLDERS.

Our Certificate of Incorporation and By-Laws contain various provisions and Delaware law contains certain provisions that could make more difficult a merger, tender offer or proxy contest involving the Company, even if such events would be beneficial to the interests of our stockholders. Such provisions could limit the price that certain investors might be willing to pay in the future for shares of our Common Stock. In addition, we may issue shares of preferred stock without stockholder approval on such terms as the Board of Directors may determine. The rights of the holders of common stock will be subject to, and may be adversely affected by, the rights of the holders of any preferred stock that may be issued in the future. Moreover, although the ability to issue preferred stock may provide flexibility in connection with possible acquisitions and other corporate purposes, such issuance may make it more difficult for a third party to acquire, or may discourage a third party from acquiring, a majority of our voting stock. We have no current plans to issue any shares of preferred stock. We may in the future adopt other measures that may have the effect of delaying, deferring or preventing a change in control. Certain of such measures may be adopted without any further vote or action by the stockholders, although we have no present plans to adopt any such measures.

IDENTIFICATION OF MATERIAL WEAKNESS IN INTERNAL CONTROL MAY ADVERSELY AFFECT OUR FINANCIAL RESULTS.

We are subject to the ongoing internal control provisions of Section 404 of the Sarbanes-Oxley Act of 2002. Those provisions provide for, among other things, the identification of material weaknesses in internal control that could indicate a lack of adequate controls to generate accurate financial statements. Though we routinely assess our internal controls, there can be no assurance that we will be able to timely remediate material weaknesses, if any, that may be identified in future periods, or maintain all of the controls necessary for continued compliance. There likewise can be no assurance that we will be able to retain sufficient skilled finance and accounting personnel, especially in light of the increased demand for such personnel among publicly traded companies. Because we are not an "accelerated filer", as defined in the Securities Exchange Act of 1934, certain provisions of Section 404 relating to the provision of a report of management and accompanying auditor's report on a company's internal controls over financial reporting will not be applicable until our first fiscal year ending on or after July 15, 2007. Based on the experiences of other issuers currently subject to the full requirements of

Section 404, we expect that we will incur substantial additional costs in order to prepare for our first required report under Section 404 and increased recurring costs thereafter.

OUR STOCK PRICE IS SUBJECT TO VOLATILITY ASSOCIATED WITH MARKET FLUCTUATIONS AS WELL AS OUR OPERATING PERFORMANCE AND LIMITED TRADING VOLUME IN OUR STOCK.

The price at which the our common stock trades is determined in the marketplace and may be influenced by many factors, including our performance, investor expectations, the trading volume in our common stock, general economic and market conditions and competition.

The market price of our common stock could fluctuate substantially due to a variety of factors, including our quarterly operating results and those of other restaurant companies, changes in general conditions in the economy, the financial markets or the restaurant industry, natural disasters or other developments affecting our business or our competitors. In addition, in recent years the stock market has experienced extreme price and volume fluctuations. This volatility has had a significant effect on the market prices of securities issued by many companies for reasons unrelated to the operating performance of these companies.

OUR DIRECTORS, EXECUTIVE OFFICERS AND SIGNIFICANT SHAREHOLDERS HOLD A SUBSTANTIAL PORTION OF OUR STOCK THAT MAY LEAD TO CONFLICTS WITH OTHER SHAREHOLDERS OVER CORPORATE GOVERNANCE.

Our directors, executive officers and current holders of 5% or more of our outstanding common stock hold a substantial portion of our stock. At March 10, 2006, Starwood Hotels and Resorts held 666,667 shares of our common stock and warrants entitling Starwood to purchase an additional 666,667 shares of our common stock at $2.00 per share. At March 10, 2006, Lewis Wolff, a director, and his family members and entities controlled by Mr. Wolff and his family members, held 501,781shares of our common stock, warrants and options to purchase an additional 246,250 shares of our common stock at prices ranging from $1.65 to $4.527 per share and 500 shares of Series II Convertible Preferred Stock that may be converted into 125,000 shares of our common stock, in addition to options held by Mr. Wolff received in his capacity as a director. Other members of senior management held in excess of 946,400 shares of our common stock, as well as options to purchase 217,983 shares of our common stock, at March 10, 2006. Such persons, acting together, and each acting alone, will be able to significantly influence all matters requiring shareholder approval, including the election of directors and significant corporate transactions, such as mergers or other business combinations.

CONVERSION OF OUR OUTSTANDING CONVERTIBLE SECURITIES COULD SUBSTANTIALLY DILUTE COMMON STOCK PRICES BECAUSE THE CONVERSION PRICES OF THOSE SECURITIES ARE BELOW OUR CURRENT MARKET PRICE.

We have issued, and may issue in the future, various securities that are convertible or exercisable at prices that are lower than the current market price of our common stock or are subject to adjustment due to a variety of factors, including fluctuations in the market price of our common stock and the issuance of securities at an exercise or conversion price less than the then-current exercise or conversion price of those securities. For example, at March 10, 2006, we had issued and outstanding 1,309,896 warrants to purchase shares our common stock at prices ranging from $2.00 to $7.00 per share. On March 10, 2006, the closing price of our common stock on the Nasdaq SmallCap Market was $3.35.

The value of our common stock could, therefore, experience substantial dilution as a result of the conversion or exercise of our outstanding derivative securities or as a result of any issuance of additional securities at prices lower than the conversion prices of such securities. Also, as a result of conversions of our Series II Convertible Preferred Stock and any related sales of our common stock by the holders, the market price of our common stock could be depressed.

OUR BUSINESS MAY BE ADVERSELY AFFECTED BY CONFLICTS OF INTEREST ASSOCIATED WITH DOING BUSINESS WITH AFFILIATES OF CERTAIN DIRECTORS AND PRINCIPAL SHAREHOLDERS.

We are presently party to business arrangements with affiliates of two directors and principal shareholders. We are party to agreements with two entities affiliated with Lewis Wolff, a director and principal shareholder. We lease the site of the San Jose Grill restaurant from an entity in which Mr. Wolff is a part owner. Similarly, we are party to an agreement with Hotel Restaurant Properties, Inc., an entity controlled by a member of Mr. Wolff's family, pursuant to which HRP assists in locating hotel locations for restaurants and pursuant to which HRP is entitled to a portion of the fees or profits from those restaurants. During 2005, we paid rents of $257,000 with respect to the San Jose Grill and paid, or accrued, management fees of $423,000 to HRP. We are also party to various agreements with Starwood Hotels and Resorts, the employer of one of our directors, Richard Dantas, and one of our principal shareholders. Under a Development Agreement, we agreed to work with Starwood to identify potential restaurant locations in Starwood properties and, subject to negotiating acceptable terms, develop and operate restaurants in Starwood properties under management or license arrangements. Pursuant to the Development Agreement, we granted certain exclusivity rights to Starwood and agreed to grant certain warrants to Starwood based on restaurant openings. As of December 31, 2005, we operated two restaurants pursuant to management agreements with Starwood. Our business dealings with Starwood and affiliates of Mr. Wolff create potential conflicts of interest that could result in our securing terms that are less favorable than might otherwise be available in the absence of such conflicts.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable

ITEM 2. PROPERTIES

With the exception of certain properties that may be operated pursuant to management arrangements or partnership or joint venture arrangements, all of our restaurants are located in space leased from unaffiliated third parties. The leases have initial terms ranging from 10 to 25 years, with varying renewal options on all but one of such leases. Most of the leases provide for a base rent plus payment of real estate taxes, insurance and other expenses, plus additional percentage rents based on revenues of the restaurant. See "Business."

The Grill restaurant in San Jose is located in space leased from a hotel management company that may be deemed to be controlled by one of our directors, Lewis Wolff.

Our executive offices are located in 5,000 square feet of office space located in Los Angeles, California. Such space is leased from an unaffiliated party pursuant to a lease expiring in May 2007.

Management believes that our existing restaurant and executive office space is adequate to support current operations. We intend to lease, from time to time, such additional office space and restaurant sites as management deems necessary to support our future growth plans.

ITEM 3. LEGAL PROCEEDINGS

Restaurants such as those we operate are subject to litigation in the ordinary course of business, most of the related costs we expect to be covered by our general liability insurance. However, punitive damages awards are not covered by general liability insurance. Punitive damages are routinely claimed in litigation actions against us. There can be no assurance that punitive damages will not be given with respect to any actions that may arise in the future.

In June 2004, one of our former hourly restaurant employees filed a class action lawsuit against us in the Superior Court of California of Orange County. We requested and were granted a motion to move the suit from Orange County to Los Angeles County. The lawsuit was then filed in the Superior Court of California of Los Angeles County in December 2004. The plaintiff has alleged violations of California labor laws with respect to providing meal and rest breaks. The lawsuit sought unspecified amounts of penalties and other monetary payments on behalf of the plaintiffs and other purported class members. We believe that all of our employees were provided with the opportunity to take all required meal and rest breaks. The case has been placed in a stay status pending the outcome of a review by the California Supreme Court on appealed cases of the same nature. We intend to vigorously defend our position in all of these matters although the outcome cannot be ascertained at this time. We have established a reserve of $150,000 for this lawsuit.

A Class Action complaint was filed in the Superior Court of the State of California for the County of Los Angeles on March 15, 2006. The plaintiff and those similarly situated (Servers) complain that the company has violated the labor code by having Servers "Tip Out" Bartenders and Expeditors a percentage of their tips to these employees who provide no direct table service. The complaint has labeled this act as "Tip-pooling." The company has not yet been served with this complaint.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY RELATED STOCKHOLDER MATTERS, AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is currently traded in the over-the-counter market and is quoted on the Nasdaq Small-Cap Market ("Nasdaq") under the symbol "GRIL".

The following table sets forth the high and low bid price per share for our common stock for each quarterly period during the last two fiscal years:

	High	Low
2004 - First Quarter	3.65	2.46

	Second Quarter	3.44	1.80
	Third Quarter	2.96	1.55
	Fourth Quarter	2.53	1.45
2005 -	First Quarter	3.05	1.81
	Second Quarter	4.23	1.85
	Third Quarter	4.60	3.01
	Fourth Quarter	4.84	3.01

The quotations reflect inter-dealer prices without retail mark-up, mark-down or commission and may not represent actual transactions.

At March 10, 2006, the closing bid price of our Common Stock was $3.35.

As of March 10, 2006, there were approximately 406 holders of record of our Common Stock.

We have never declared or paid any cash dividend on our Common Stock and do not expect to declare or pay any such dividend in the foreseeable future.

ITEM 6. SELECTED FINANCIAL DATA

The following tables present selected historical consolidated financial data derived from our consolidated financial statements. The following data should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our consolidated financial statements included elsewhere herein.

	Fiscal Year Ended December				
	2005	2004	2003	2002	2001
	(In thousands except per share data)				
Statement of Operations Data:					
Sales	$ 54,706	$ 49,938	$ 45,858	$ 41,826	$ 45,02
Cost reimbursements	14,299	12,439	9,728	7,270	3,59
Management and license fees	1,683	1,282	1,037	901	77
Total revenues	70,688	63,659	56,623	49,997	49,38
Operating expenses:					
Cost of sales	15,446	14,465	13,274	11,927	12,91
Restaurant operating expenses	32,844	30,552	28,050	25,649	27,10
Reimbursed costs	14,299	12,439	9,772	7,557	3,59
General and administration	4,868	4,472	3,696	3,426	3,38
Depreciation and amortization	2,248	2,005	1,816	1,868	1,83
Pre-opening costs	301	167	182	69	19
Gain on sale of assets	(5)	(2)	(11)	(71)	(22
Total operating expenses	70,001	64,098	56,779	50,425	48,8
Income (loss) from operations	687	(439)	(156)	(428)	58
Interest expense, net	(128)	(272)	(331)	(331)	(56

Income (loss) before taxes and minority interest	559	(711)	(487)	(792)	2
Provision for income taxes	(179)	(65)	(89)	(37)	(
Minority interest	559	814	704	422	11
Net income (loss)	939	38	128	(407)	6
Preferred dividends accrued	(50)	(50)	(50)	(50)	(5
Net income (loss) applicable to common stock	$ 889	$ (12)	$ 78	$ (457)	$ 1
Net income (loss) per share applicable to common stock:					
Basic	$ 0.16	$ 0.00	$ 0.01	$ (0.08)	$ 0.0
Diluted	$ 0.14	$ 0.00	$ 0.01	$ (0.08)	$ 0.0
Weighted average shares outstanding					
Basic	5,691,523	5,608,541	5,537,071	5,537,071	4,776,74
Diluted	6,251,042	5,608,541	5,640,842	5,537,071	4,776,74

	Fiscal Year Ended December				
	2005	2004	2003	2002	2001
	(In thousands except per share data)				
Balance Sheet Data:					
Working capital surplus (deficit)	$ (1,277)	$ 209	$ 378	$ (1,045)	$ (62
Total assets	21,973	19,749	17,047	16,579	17,32
Long-term debt, less current portion	877	977	1,254	1,743	2,37
Stockholders' equity	4,806	3,830	3,744	3,616	4,02

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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 the sections entitled "Risk Factors" beginning on page of 15 and "Certain Factors Affecting Future Operating Results" beginning on page 37 of this Form 10-K.

GENERAL

Grill Concepts 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."

Our revenues are derived from sales at company-owned restaurants, management and license fees from restaurants managed or licensed by us and reimbursements of operating expenses of managed outlets.

During the fiscal year ended December 25, 2005, we owned and operated, for the full fiscal year, fourteen restaurants (ten Daily Grill and four Grill restaurants), including two Daily Grill and three Grill restaurants owned in partnership with third parties. During fiscal 2005, we also operated one fully owned Daily Grill that opened in March, one Daily Grill owned in partnership that opened in May and one fully owned Daily Grill which closed in July.

Also during fiscal 2005, we managed or licensed, for the full fiscal year, six Daily Grill restaurants.

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During the fiscal year ended December 26, 2004, we owned and operated, for the full fiscal year, fourteen restaurants (ten Daily Grill and four Grill restaurants), including two Daily Grill and three Grill restaurants owned in partnership. During 2004, we also operated one owned Daily Grill that opened in January.

Also during fiscal 2004, we managed or licensed, for the full fiscal year, six Daily Grill restaurants. During fiscal 2004, we commenced management of one Daily Grill that opened in November and terminated our license relating to the San Jose City Bar and Grill.

Sales revenues are derived from sales of food, beer, wine, liquor and non-alcoholic beverages. Approximately 79% of combined 2005 sales were food and 21% were beverage. Sales revenues from restaurant operations are primarily influenced by the number of restaurants in operation at any time, the timing of the opening of such restaurants and the sales volumes of each restaurant.

Management and license fee revenues are derived from individually negotiated arrangements by which we manage restaurants on behalf of third parties or license to third parties the right to operate Daily Grill restaurants. Management and license fees are primarily influenced by the number of management and license arrangements in place, the negotiated management or license fee and the revenues of the managed or licensed restaurants. Management and license fees typically range from five to eight percent of gross sales of the subject restaurants. Management and license fee revenues also include incentive fees we receive which are based on a percentage of net income.

Revenues derived from reimbursement of operating expenses of managed outlets relate to contractual undertakings relating to managed restaurants wherein we assume responsibility for some or all operating expenses of managed restaurants and the restaurant owner undertakes to reimburse all of those expenses. Pursuant to the guidance of EITF 01-14 and EITF 99-19, we are considered to be the primary obligor with respect to the reimbursed expenses and, as such, report the reimbursed expenses as revenues with the expenses being reported as "Reimbursed Costs" under operating expenses.

Expenses are comprised primarily of cost of food and beverages, restaurant operating expenses, including payroll, rent and occupancy costs and reimbursed costs. Our largest expenses are payroll and the cost of food and beverages, which is primarily a function of the price of the various ingredients utilized in preparing the menu items offered at our restaurants. Restaurant operating expenses consist primarily of wages paid to part-time and full-time employees, rent, utilities, insurance and taxes. Reimbursed costs are costs incurred on behalf of managed restaurants that are reimbursable by the managed restaurant. We typically analyze these costs as a percentage of restaurant sales, not total revenues.

In addition to restaurant operating expenses, we pay certain general and administrative expenses that relate primarily to operation of our home office. Home office general and administrative expenses consist primarily of salaries of officers, management personnel and clerical personnel, rent, legal and accounting costs, travel, insurance and office expenses.

RESULTS OF OPERATIONS

The following table sets forth certain items as a percentage of total revenues from our Statements of Operations during 2005, 2004 and 2003. As noted above, we typically analyze our operating expenses as a percentage of sales revenues, not total revenues.

	Fiscal Year Ended December		
	2005	2004	2003
Sales revenues	77.4%	78.5%	81.0%
Cost reimbursements	20.2	19.5	17.2
Management and licensing fees	2.4	2.0	1.8
Total revenues	100.0	100.0	100.0

Cost of sales	21.8	22.7	23.4
Restaurant operating expense	46.4	48.0	49.5
Reimbursed costs	20.2	19.5	17.3
General and administrative expense	6.9	7.0	6.5
Depreciation and amortization	3.2	3.2	3.2
Pre-opening costs	0.4	0.3	0.3
Total operating expenses	99.0	100.7	100.3
Operating income (loss)	1.0	(0.7)	(0.3)
Interest expense, net	(0.2)	(0.4)	(0.6)
Income (loss) before income tax and minority interest	0.8	(1.1)	(0.9)
Provision for taxes	(0.3)	(0.1)	(0.2)
Minority interest	0.8	1.3	1.3
Net income	1.3%	0.1%	0.2%

FISCAL YEAR 2005 COMPARED TO FISCAL YEAR 2004

Revenues. Revenues for 2005 increased 11.0% to $70.7 million from $63.7 million in 2004. Sales revenues increased 9.6% to $54.7 million in 2005 from $49.9 million in 2004. Reimbursed managed outlet operating expenses increased 15.0% to $14.3 million from $12.4 million in 2004. Management and license fee revenues increased to $1.7 million in 2005 from $1.3 million in 2004. The restaurant sales information excludes revenue related to reimbursed operating expenses and management and license fees.

Sales for Daily Grill restaurants increased by 9.5% from $33.8 million in 2004 to $37.0 million in 2005. The increase in sales revenues for the Daily Grill restaurants from 2004 to 2005 was primarily attributable to opening of the Downtown Daily Grill ($2.1 million) and the Santa Monica Daily Grill ($1.9 million), a slight increase at the Bethesda Daily Grill which opened in January 2004 ($0.1 million) and an increase in same store sales of 1.1% ($0.3 million) for restaurants open for 12 months in both 2005 and 2004 offset by a decrease in sales at the LaCienega Daily Grill which closed in July 2005 ($1.2 million). Weighted average weekly sales at the Daily Grill restaurants increased 2.9% from $57,757 in 2004 to $59,456 in 2005.

Sales for Grill restaurants increased by 9.8% from $16.1 million in 2004 to $17.7 million in 2005. The increase in sales revenues for the Grill restaurants from 2004 to 2005 was primarily attributable to increased guest counts supported by improved check averages. Weighted average weekly sales at the Grill restaurants increased 9.8% from $77,545 in 2004 to $85,110 in 2005.

Price increases were implemented during the fourth quarter of 2005 for a large percentage of the menu items. Selected price increases may be implemented from time to time in the future, consistent with the casual dining industry and how the economy fares. Future revenue growth is expected to be driven principally by a combination of expansion into new markets and the opening of additional restaurants and establishment of market share in those new markets as well as increases in guest count at existing restaurants and selected price increases. When entering new markets where we have not yet established a market presence, sales levels are expected to be lower than in existing markets where we have a concentration of restaurants and high customer awareness. Although our experience in developing markets indicates that the opening of multiple restaurants within a particular market results in increased market share, decreases in comparable restaurant sales could result.

Cost reimbursements increased in 2005 primarily due to the full year operation of the Long Beach Daily Grill and improved sales at other managed restaurants.

Management and license fee revenues during 2005 were attributable to (1) restaurant management services relating to six hotel based restaurants which accounted for $1,462,000 of management fees, and (2) licensing fees from the two licensed Daily Grill restaurants which totaled $221,000. The increase in management and license fees during 2005 was attributable to (1) management of one Daily Grill open a full year compared to 6 weeks in 2004, (2) 10% or more

increases in sales at three managed Daily Grills and (3) a 10% sales increase at one licensed Daily Grill, partially offset by the termination in 2004 of our licensed San Jose City Bar and Grill operation.

Operating Expenses and Operating Results. Total operating expenses, including cost of sales, restaurant operating expenses, reimbursed costs, general and administrative expense, depreciation and amortization, and pre-opening costs, increased 9.2% to $70.0 million in 2005 from $64.1 million in

2004.

Cost of Sales. Cost of sales consists exclusively of the cost of food and beverages sold. Cost of sales increased by 6.8% ($1.0 million) and decreased almost a full percentage point to 28.2% as a percentage of sales in 2005 compared to 29.0% in 2004. The increase in cost of sales was attributable to the opening of new restaurants and increased sales generally. The decrease in cost of sales as a percentage of sales reflects a combination of improved cost controls, purchasing efficiencies and price increases.

Restaurant Operating Expenses. Restaurant operating expenses consist of wages and benefits of restaurant personnel and all other operating expenses. The operating expenses include, but are not limited to, supplies, advertising, occupancy, maintenance and utilities. Restaurant operating expenses increased 7.5% to $32.8 million in 2005 from $30.6 million in 2004. As a percentage of sales, restaurant operating expenses represented 60.0% in 2005 and 61.2% in 2004. The increase in restaurant operating expenses was primarily attributable to the opening during 2005 of two Daily Grills accounting for $2.5 million of the increased costs partially offset by the closing of one restaurant resulting in a decrease of $0.8 million. For comparable restaurants the expenses as a percentage of sales improved slightly to 60.0% from 60.2% in 2004.

Reimbursed Costs. Reimbursed costs increased 15.0% from $12.4 million in 2004 to $14.3 million in 2005. These expenses represent the operating costs for which we are the primary obligor of the restaurants we do not consolidate. The increase is primarily due to the full year operations of one Daily Grill that was open for only six weeks in 2004 and improved sales at other restaurants.

General and Administrative. General and administrative expenses rose to $4.9 million in 2005 compared to $4.5 million in 2004. General and administrative expenses represented 6.9% of total revenues in 2005 as compared to 7.0% of total revenues in 2004. The dollar increase was primarily the result of corporate level bonuses ($375,000), a reserve for settlement of the meals and breaks lawsuit ($150,000) and increased professional services ($27,000), offset by decreased office expenses ($87,000), travel expenses ($36,000) and bad debt due to continued under performance at the Portland Daily Grill ($23,000).

Depreciation and Amortization. Depreciation and amortization expense was $2.2 million during 2005 and $2.0 million in 2004. The increase was due primarily to the addition of two Daily Grills during 2005.

Pre-opening costs. Pre-opening costs totaled $301,000 in 2005 as compared with $167,000 in 2004. These pre-opening costs were attributable to the opening of two Daily Grills in 2005 and the opening of one Daily Grill in 2004.

Interest Expense. Interest expense, net, totaled $128,000 during 2005 as compared to $272,000 in 2004. The decrease in interest expense was primarily attributable to substantially reduced warrant amortization in 2005 and lower interest on maturing debt combined with interest earned on funds in restricted accounts.

Provision for income taxes. The 2005 provision for income tax is comprised of amounts for federal and state taxes reduced by the income tax benefit resulting from the recognition of deferred tax asset that is considered more likely than not to be realized of $0.6 million. The provision for income taxes differs from the amount of income tax expense that would result from applying the domestic federal statutory tax rates to pretax income primarily due to the change in the deferred income tax valuation allowance, minority interests' share of net loss of subsidiaries and the impact of state income taxes.

Minority Interest. We reported a minority interest in the loss of our majority owned subsidiaries of $559,000 during 2005, consisting of a minority interest in the earnings of San Jose Grill on the Alley, LLC of $162,000, a minority interest in the loss of The Grill on Hollywood, LLC of $109,000, a minority interest in the loss of The Daily Grill at Continental Park, LLC of $194,000, a minority interest in the loss of the 612 Flower Daily Grill LLC of $138,000 and a partnership loss in the Universal CityWalk Daily Grill of $280,000. During 2004 we reported a minority interest in the loss of our

majority owned subsidiaries of $814,000, consisting of a minority interest in the earnings of San Jose Grill on the Alley, LLC of $154,000, a minority interest in the loss of The Grill on Hollywood, LLC of $357,000, a minority interest allocation from The Daily Grill at Continental Park of $483,000, a minority interest in the loss of the 612 Flower Daily Grill LLC of $3,000and partnership loss in the Universal CityWalk Daily Grill of $125,000. The Company allocates profits and losses to the minority interest in its partially owned subsidiaries based on the underlying economics of the investment. These may or may not reflect the Company's ownership percentage and can be inconsistent with the allocation provisions specified in the joint venture agreements. Where there is a disparity among the ownership percentages, the terms of the agreements and the underlying economics, the Company utilizes a hypothetical liquidation model to allocate profits and losses. Under this model, all of the venture's assets and liabilities as reflected in the balance sheet are assumed to be realized at their GAAP carrying values. The hypothetical liquidating proceeds are calculated at the end of each period and applied to the capital accounts as would occur under a true liquidation scenario. The change in this balance from period to period represents the investors' share of the income or loss.

Net Income. We reported a net income of $939,000 in 2005 as compared to a net income of $38,000 in 2004.

FISCAL YEAR 2004 COMPARED TO FISCAL YEAR 2003

Revenues. Revenues for 2004 increased 12.4% to $63.7 million from $56.6 million in 2003. Sales revenues increased 8.9% to $49.9 million in 2004 from $45.9 million in 2003. Reimbursed managed outlet operating expenses increased 27.9% to $12.4 million from $9.7 million in 2003. Management and license fee revenues increased to $1.3 million in 2004 from $1.0 million in 2003. The restaurant sales information excludes revenue related to reimbursed operating expenses and management and license fees.

Sales for Daily Grill restaurants increased by 12.5% from $30.1 million in 2003 to $33.8 million in 2004. The increase in sales revenues for the Daily Grill restaurants from 2003 to 2004 was primarily attributable to an increase in same store sales of 4.6% ($1.3 million) for restaurants open for 12 months in both 2004 and 2003 and opening of the Bethesda Daily Grill ($2.9 million). Weighted average weekly sales at the Daily Grill restaurants decreased 1.1% from $58,052 in 2003 to $57,757 in 2004.

Sales for Grill restaurants increased by 2.1% from $15.8 million in 2003 to $16.1 million in 2004. The increase in sales revenues for the Grill restaurants from 2003 to 2004 was attributable to the improved check averages partially offset by decreased guest counts. Weighted average weekly sales at the Grill restaurants increased 2.1% from $75,971 in 2003 to $77,545 in 2004.

Price increases were last implemented during the first quarter of 2003 for certain menu items.

Cost reimbursements increased in 2004 primarily due to the full year operation of Portland Daily Grill, the opening of Long Beach Daily Grill and improved sales at other managed restaurants.

Management and license fee revenues during 2004 were attributable to (1) hotel restaurant management services which accounted for $1,073,000 of management fees, and (2) licensing fees from the LAX Daily Grill, Skokie, Illinois Daily Grill and the San Jose City Bar and Grill which totaled $209,000. The increase in management fees during 2004 was attributable to (1) management of the Portland Daily Grill open a full year compared to 15 weeks in 2003, (2) a 26.6% increase in sales at the San Francisco Daily Grill and (3) sales increase of over 6% at the Georgetown Daily Grill, Burbank Daily Grill and Houston Daily Grill. We terminated the licensed operation of the San Jose City Bar and Grill in 2004.

Operating Expenses and Operating Results. Total operating expenses, including cost of sales, restaurant operating expenses, reimbursed costs, general and administrative expense, depreciation and amortization, and pre-opening costs, increased 12.9% to $64.1 million in 2004 from $56.8 million in 2003.

Cost of Sales. Cost of sales consists exclusively of the cost of food and beverages sold. Cost of sales increased by 9.0% ($1.2 million) and increased slightly as a percentage of sales to 29.0% in 2004 compared to 28.9% in 2003. The increase in cost of sales reflects the opening of new restaurants and higher revenues, generally. The slight increase in cost of sales as a percentage of sales reflects fluctuation in food costs.

Restaurant Operating Expenses. Restaurant operating expenses consist of wages and benefits of restaurant personnel and all other operating expenses. The operating expenses include, but are not limited to, supplies, advertising, occupancy, maintenance and utilities. Restaurant operating expenses increased 8.9% to $30.6 million in 2004 from $28.1 million in 2003. As a percentage of sales, restaurant operating expenses represented 61.2% in both 2004 and 2003. The opening during 2004 of the Bethesda Daily Grill accounted for $1.9 million of the increase. For comparable restaurants the expenses as a percentage of sales improved slightly to 60.3% from 60.5% in 2003.

Reimbursed Costs. Reimbursed costs increased 27.3% from $9.8 million in 2003 to $12.4 million in 2004. These expenses represent the operating costs for which we are the primary obligor of the restaurants we do not consolidate. The increase is primarily due to the full year operations of the Portland Daily Grill, the opening of the Long Beach Daily Grill and improved sales at other restaurants.

General and Administrative. General and administrative expenses rose to $4.5 million in 2004 compared to $3.7 million in 2003. General and administrative expenses represented 7.0% of total revenues in 2004 as compared to 6.5% of total revenues in 2003. The increase was the result of higher payroll and related benefits related to building staff for our growth ($367,000), increased professional services ($248,000), increased travel due to new locations ($76,000), and reserve for uncollected management fees ($109,000).

Depreciation and Amortization. Depreciation and amortization expense was $2.0 million during 2004 and $1.8 million in 2003. The increase was due primarily to the addition of the Bethesda Daily Grill.

Pre-opening costs. Pre-opening costs totaled $167,000 in 2004 as compared with $182,000 in 2003. These pre-opening costs were attributable to the opening in January 2003 of the South Bay Daily Grill and the opening of the Bethesda Daily Grill in January 2004.

Interest Expense. Interest expense, net, totaled $272,000 during 2004 as compared to $331,000 in 2003. The decrease in interest expense was primarily attributable to reduced debt levels as a result of the maturing of loans.

Provision for income taxes. The income tax provision for 2004 and 2003 are due mainly to state taxes as the company has a federal net operating loss to carry forward. The tax rates in 2004 and 2003 were comprised of the federal and state statutory rates, less any permanent items and tax credits based on the annual estimated effective tax rates for the respective years.

Minority Interest. We reported a minority interest in the loss of our majority owned subsidiaries of $814,000 during 2004, consisting of a minority interest in the earnings of San Jose Grill on the Alley, LLC of $154,000, a minority interest in the loss of The Grill on Hollywood, LLC of $357,000, a minority interest in the loss of The Daily Grill at Continental Park, LLC of $483,000, a minority interest in the loss of the 612 Flower Daily Grill LLC of $3,000 and a partnership loss in the Universal CityWalk Daily Grill of $125,000. During 2003 we reported a minority interest in the loss of our majority owned subsidiaries of $704,000, consisting of a minority interest in the earnings of San Jose Grill on the Alley, LLC of $141,000, a minority interest in the loss of The Grill on Hollywood, LLC of $366,000 and a minority interest allocation from The Daily Grill at Continental Park of $334,000 and partnership loss in the Universal CityWalk Daily Grill of $145,000. The Company allocates profits and losses to the minority interest in its partially owned subsidiaries based on the underlying economics of the investment. These may or may not reflect the Company's ownership percentage and can be inconsistent with the allocation provisions specified in the joint venture agreements. Where there is a disparity among the ownership percentages, the terms of the agreements and the underlying economics, the Company utilizes a hypothetical liquidation model to allocate profits and losses. Under this model, all of the venture's assets and liabilities as reflected in the balance sheet are assumed to be realized at their GAAP carrying values. The hypothetical liquidating proceeds are calculated at the end of each period and applied to the capital accounts as would occur under a true liquidation scenario. The change in this balance from period to period represents the investors' share of the income or loss.

Net Income. We reported a net income of $38,000 in 2004 as compared to a net income of $128,000 in 2003.

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LIQUIDITY AND CAPITAL RESOURCES

CASH POSITION AND SHORT-TERM LIQUIDITY. At December 25, 2005, we had a working capital deficit of $1.3 million and a cash balance of $3.2 million as compared to a working capital surplus of $0.2 million and a cash balance of $1.4 million at December 26, 2004.

The increase in our cash position reflects the following cash flows:

	2005	2004	2003
Net cash provided by operating activities	$ 4,567,000	$ 4,133,000	$1,845,000
Net cash used in investing activities	(3,962,000)	(3,671,000)	(767,000)
Net cash provided (used in) financing activities	1,149,000	(551,000)	(872,000)

Net increase (decrease) in cash and cash equivalents	$ 1,754,000	$ (89,000)	$ 206,000

Included in cash flows from operating activities were tenant improvement allowances of $1.9 million in 2005, $2.1 million in 2004 and $1.8 million in 2003.

The adverse change in working capital position was principally attributable to an increase in accrued expenses of $1.9 million which, in turn, was attributable to the two new restaurants, executive and restaurant bonuses, and increased reserve for worker's compensation claims. The increase in accrued expenses favorably effected our cash provided from operations in 2005.

Our need for capital resources historically has resulted from, and for the foreseeable future is expected to relate primarily to, the construction and opening of new restaurants. Funds necessary to operate restaurants under management agreements are usually funded by cash generated by the restaurants. Sales from these outlets are deposited into an agency account belonging to the owner and we pay the outlet operating expenses, including our fee, from this agency account. Historically, we have funded our day-to-day operations through operating cash flows that have ranged from a $1.8 to $4.6 million over the past three fiscal years. Growth has been funded through a combination of bank borrowing, loans from stockholders/officers, the sale of debentures and stock, loans and tenant allowances from certain of our landlords, and, beginning in 1999, through joint venture arrangements.

FINANCING FACILITIES. At December 25, 2005, the Company had $143,000 owing under equipment leasing financing transactions, an obligation to a member of Chicago - The Grill on the Alley, LLC of $0.8 million for a guaranteed return of its invested capital, loans from stockholders/officers/directors of $0.2 million, and loans/advances from a landlord of $0.1 million.

On August 1, 2000, we received a $400,000 loan from private individuals. The loan bears interest at 9% and is payable in monthly installments over four years. In connection with the loan, we issued 40,000 warrants. In June 2001 the lender became a member of our Board of Directors and the loan was reclassified as related party debt. The loan had been paid in full at December 26, 2004.

We have a bank credit facility which will expire August 4, 2006. The terms of the bank credit facility provide for financing in the form of a revolving line of credit in the amount of $500,000, an irrevocable standby letter of credit in the amount of $860,000, increased to $1,010,000 in January 2006, and equipment financing in the amount of $500,000. In November 2005 we amended the equipment financing portion of the facility increasing the amount to $600,000 for equipment to be delivered on or before June 30, 2006, with payments to be for terms of three to five years with interest at the banks reference rate. The facility is secured by assets and is subject to certain standard borrowing covenants. We have not utilized any funds from the current or prior lines of credit dating back to 2001 and only utilized $158,000 of equipment leasing. Interest is at the bank's variable reference rate.

In March 2006 we signed a new financing agreement at which time the previous line was terminated. The Credit Agreement provides for a revolving term loan (the "Loan") to the Company of the lesser of (1) $8.0 million, or (2) 2.25 times the Company's trailing 12 month EBITDA. Funds may be borrowed under the Credit Agreement, subject to satisfaction of all conditions of funding, in minimum monthly advances of $500,000. Proceeds of the Loan may be used to pay expenses of the Loan and for general corporate purposes. The interest rate on the Loan is, at the option of the Company and subject to certain limitations on the use of LIBOR based loans, equivalent to either (1) prime rate, but not less than 7%, plus an applicable margin, or (2) the London Interbank Offered Rate, but not les than 4%, plus an applicable margin. The margin, in each case, varies based upon the Company's leverage ratio (funded debt to EBITDA, each as defined) and ranges from 2.75% to 3.50% with respect to prime rate loans and 5.50% to

6.25% with respect to LIBOR loans. The current interest rate is equal to 10.5% and will be adjusted quarterly commencing in the fourth quarter of 2006.

The Credit Agreement provides that the Company will pay all expenses incurred in connection with the Loan, including expenses incurred by the Lender. By separate agreement, the Company agreed to pay certain fees associated with the Loan, including a loan fee of $120,000, an unused line fee of 0.5% of the unused portion of the credit facility payable monthly, a loan servicing fee of $3,000 per month.

The Loan matures, and is payable in full, on March 9, 2011 subject to mandatory prepayment to the extent, if any, that the outstanding principal balance of the Loan exceeds 2.25 times trailing 12 month EBITDA or upon the occurrence of certain defined extraordinary events. The Company may prepay amounts owing under the Credit Agreement subject to payment of a prepayment premium of (1) 3% with respect to prepayments occurring on or before March 9, 2007, and (2) 1% with respect to prepayments occurring after March 9, 2007 and on or before March 9, 2008.

The Company's obligations under the Credit Agreement are secured by a first lien on all of the Company's assets, including all of the capital stock and other equity interests held by the Company in its subsidiaries, subject to existing liens on such assets. The Loan requires the Company to comply with certain ordinary lending covenants. These include, among others, financial covenants relating to maximum debt to EBITDA ratio, minimum EBITDA and maximum capital expenditures. The Company must also comply with certain information requirements, including providing periodic financial statements and projections as well as notices of defaults, litigation and other matters, maintenance of insurance and compliance with laws as well as limitations on liens and encumbrances, indebtedness, dispositions, dividends and retirement of capital stock, consolidations and mergers, changes in nature of business and other operating, financial and structural limitations.

Events of default in the Credit Agreement include, among others, (a) the failure to pay when due the obligations owing under the Credit Agreement, (b) the failure to perform and not timely remedy certain covenants, (c) certain cross defaults or cross accelerations, (d) the occurrence of bankruptcy or insolvency events, (e) the failure to make certain payments, or the occurrence of certain events, relating to retirement plans, (f) certain adverse judgments against the Company or any of its subsidiaries, (g) certain changes in ownership of the Company's stock or the board of directors, or (h) the occurrence of, and failure to remedy, a Material Adverse Effect (as defined in the Credit Agreement). Upon the occurrence of an event of default, the Lender may terminate the loan commitment and declare the Loan due and payable in full.

On March 31, 2006, the Company borrowed $1 million under the terms of the Credit Agreement with Diamond Creek Investment Partners LLC. The borrowed funds were primarily used to retire $930,132 of collateralized subordinated notes and manditorily redeemable capital obligations owed to The Michigan Avenue Group ("MAG") by the Company's subsidiary Chicago - The Grill on the Alley LLC ("Chicago Grill LLC"), and guaranteed by the Company, with the balance used for general working capital. The retired obligations related to the initial funding provided by MAG, as a member/investor in Chicago Grill LLC, with respect to the Company's The Grill on the Ally restaurant in Chicago.

OPERATING LEASES. During 2005, we, and our subsidiaries, were obligated under eighteen leases covering the premises in which our Daily Grill and Grill Restaurants are located as well as leases on our executive offices. Such restaurant leases and the executive office lease contain minimum rent provisions which provided for the payment of minimum aggregate annual rental payments of approximately $3.3 million in 2005 and percentage rent obligations, above and beyond minimum rent, of $0.6 million. Our minimum rent obligations for 2006 are $3.6 million.

CONTRACTUAL OBLIGATIONS. Our only material contractual obligations requiring determinable future payments on our part are various notes payable and our leases relating to our executive offices and restaurants, each of which is described above.

The following table details our contractual obligations as of December 25, 2005:

	Payments due by period				
	Total	2006	2007 - 2008	2009 - 2010	Thereafter
Long-term debt (1)	$ 1,237,000	$ 361,000	$ 463,000	$ 361,000	$ 52,000
Capital lease obligations	-	-	-	-	-
Operating lease commitments	30,139,000	3,647,000	7,324,000	6,061,000	13,107,000
Other contractual purchase Obligations	-	-	-	-	-
Other long-term liabilities	-	-	-	-	-
Total	$31,376,000	$ 4,008,000	$ 7,787,000	$ 6,422,000	$13,159,000