

HALLWOOD GROUP INC

Form 10-Q/A

August 25, 2005

**Table of Contents**

**SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**Form 10-Q/A**

MARK ONE

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

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

**FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_**

**For the Period Ended June 30, 2005 Commission File Number: 1-8303**

**The Hallwood Group Incorporated**  
(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of incorporation or organization)

**51-0261339**  
(I.R.S. Employer Identification Number)

**3710 Rawlins, Suite 1500**  
**Dallas, Texas**  
(Address of principal executive offices)

**75219**  
(Zip Code)

Registrant's telephone number, including area code: (214) 528-5588

**Securities Registered Pursuant to Section 12(b) of the Act:**

<b>Title of Class</b>	<b>Name of Each Exchange On Which Registered</b>
Common Stock (\$0.10 par value)	American Stock Exchange

**Securities Registered Pursuant to Section 12(g) of the Act:**

**Title of Class**

Series B Redeemable Preferred Stock

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES  NO

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12B-2 of the Act).

YES  NO

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

YES  NO

1,511,218 shares of Common Stock, \$.10 par value per share, were outstanding at July 31, 2005.



**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES  
EXPLANATORY NOTE**

This Form 10-Q/A amendment to the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2005 is being filed to amend certain disclosures in Part I, Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations related to the portion of total sales attributable to military sales and to sales to a major customer by the Company's Brookwood subsidiary, which were reported incorrectly due to a clerical error.

The total sales reported in the Company's financial statements for the three months and six months ended June 30, 2005 and 2004 are unchanged. All other information in the Form 10-Q, including the financial statements, is unchanged from the original filing. This filing amends only the disclosures related to military sales and sales to a major customer and does not otherwise update the disclosures in the Form 10-Q as originally filed and does not reflect events occurring after the original filing of the Form 10-Q.

Provided below is a schedule indicating sales information, as originally filed, and corrected information (in thousands):

	2005 Periods		2004 Periods	
	As Reported	Corrected	As Reported	Corrected
<b>SECOND QUARTER</b>				
Military Sales	\$ 13,479	\$ 18,158	\$ 13,124	\$ 19,621
Major Customer	11,625	15,309	9,071	12,929
<b>SIX MONTH PERIOD</b>				
Military Sales	\$ 35,084	\$ 39,762	\$ 29,588	\$ 36,085
Major Customer	29,802	33,485	19,636	23,494

The financial statements and related footnotes in the originally filed Form 10-Q are not included with this Form 10-Q/A as they are unchanged. Disclosures in the following paragraphs of Management's Discussion and Analysis of Financial Condition and Results of Operations are effected by the changes in the supplemental disclosures: Overview Brookwood, Revenues and Expenses.

Page 2

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES  
TABLE OF CONTENTS**

ITEM NO.		PAGE
	<b>PART I FINANCIAL INFORMATION</b>	
2	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	4
	<b>PART II OTHER INFORMATION</b>	
	<u>Signature Page</u>	17
	<u>Index to Exhibits</u>	18
	<u>Certification of CEO Pursuant to Section 302</u>	
	<u>Certification of CFO Pursuant to Section 302</u>	
	<u>Certification of CEO &amp; CFO Pursuant to Section 906</u>	

Page 3

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**Overview**

*General.* Until July 2004, the Company was a diversified holding company with interests in textiles, real estate and energy. Since that time, the Company has disposed of its interests in Hallwood Realty Partners, L.P. ( HRP ), which constituted substantially all of its real estate activities, and its minority investments in Hallwood Energy Corporation ( HEC ) and Hallwood Energy III, L.P ( HE III ). The Company received total cash proceeds from these transactions in the amount of approximately \$178,000,000, including approximately \$55,000,000 in July 2005 from the disposition of HE III. These proceeds were used to repay bank debt, the Company's 10% Debentures and other obligations. In addition, the Company paid a cash distribution in partial liquidation to its stockholders of approximately \$56,789,000 (\$37.70 per share) on May 27, 2005, and the board of directors has declared an additional cash distribution in partial liquidation of approximately \$9,300,000 (\$6.17 per share) payable on August 18, 2005 to stockholders of record on August 12, 2005. The Company had approximately \$68,000,000 in cash and marketable securities at August 12, 2005.

*Continuing Operations.* The Company derives substantially all of its revenues from continuing operations from the textile activities of its Brookwood subsidiary, and consequently, the Company's success is highly dependent upon Brookwood's success. Although the Company's textile activities have generated substantial positive cash flow in recent years, there is no assurance that this trend will continue. In addition, the remaining energy entities will require significant additional capital investment over the next few years to acquire additional properties and to adequately explore and develop existing and newly acquired properties.

*Brookwood.* Brookwood's success will be influenced in varying degrees by its ability to continue sales to existing customers, cost and availability of supplies, Brookwood's response to competition, its ability to generate new markets and products, and the effect of trade regulation.

While Brookwood has enjoyed substantial growth in its military business during each of the past three years, there is no assurance this trend will continue. The U.S. government is releasing contracts for shorter periods than in the past. Therefore, Brookwood's flow of orders from the companies from whom it derives its military business has been more volatile. Although military sales for the six months of 2005 were 10% higher than the comparable period in 2004, military sales for the 2005 second quarter declined 7% from the comparable 2004 period. Based on orders received through July 31, 2005, Brookwood's management believes that military sales may decline during the remainder of 2005. Orders from the military for goods generally were significantly affected by the increased activity of the U.S. military in recent years. If this activity does not continue to increase or declines, then orders from the military generally, including orders for Brookwood's products, may be similarly affected. However, the Company is unable at this time to predict future sales trends.

Unstable global nylon pricing is creating cost increases, which, together with product mix, are beginning to soften Brookwood's margins, a trend that is likely to continue.

Brookwood continues to identify new market niches to replace sales lost to importers. In addition to its existing products and proprietary technologies, Brookwood has been developing advanced breathable, waterproof laminate materials, which have been well received by its customer base. Continued development of these fabrics for military, industrial and consumer applications is a key element of Brookwood's business plan. The ongoing enterprise value of Brookwood is contingent on its ability to adapt to the global textile industry; however, there can be no assurance that the positive results of the past can be sustained or that competitors will not aggressively seek to replace products sold by Brookwood.

The textile industry is also significantly affected by legislation and administrative actions restricting or liberalizing trade among world textile producing and consuming countries such as the North American Free Trade Agreement ( NAFTA ), the World Trade Organization ( WTO ), the anti-dumping and countervailing duty remedies and enforcement activities by the U.S. Government, and the value of the United States dollar in relation to other currencies and world economic developments. However, under NAFTA there are no textile and apparel quotas between the United States and either Mexico or Canada for products that meet certain origin criteria. Tariffs among the three countries are either already zero or are being phased out. Also, the WTO recently phased out textile and apparel

quotas. The United States has also approved the Central American Free Trade Agreement ( CAFTA ) with five Central American countries (Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua). Under CAFTA, textile and apparel originating from CAFTA countries will be duty and quota-free, provided that yarn formed in the United States or other CAFTA countries is used to produce the fabric. In addition, the United States recently implemented bilateral free trade agreements with Chile, Australia, Israel, Jordan and Singapore. Although these actions have the effect of

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

exposing Brookwood's market to the lower price structures of the other countries and, therefore, continuing to increase competitive pressures, management is not able to predict their specific impact.

*Energy.* Since January 2002, the Company has invested approximately \$22,180,000 in various private energy companies. The Company owns between 20% and 28% of the entities (between 16% and 22% on a fully diluted basis) and accounts for the investments using the equity method of accounting. These private energy companies are or have been principally involved in drilling, gathering and sale of natural gas in the Barnett Shale formation of Johnson County, Texas and surrounding counties, and conducting 3-D seismic surveys over optioned land in South Louisiana to determine if further oil and gas exploratory activity is warranted.

On July 18, 2005, HE III completed a merger with Chesapeake. The merger agreement provided for a total price of \$246,500,000 for all of the HE III production and reserves, as well as the operational and administrative infrastructure in Johnson County, and was subject to reduction for outstanding debt, transaction costs, changes in working capital and certain other matters. After these reductions and adjustments, Chesapeake paid a total of approximately \$235,000,000 at the closing, including debt owed by HE III, and management of HE III anticipates that an additional \$2,500,000 will be paid upon final calculation of working capital.

In exchange for its interest in HE III, the Company received a cash payment of \$54,800,000 in July 2005 and anticipates that it will receive an additional \$600,000 after calculation of HE III's working capital is completed. The Company will report the gain from the disposition of its investment in the 2005 third quarter.

The Company's Hallwood Petroleum, LLC subsidiary ( HPL ) commenced operation in October 2004 as an administrative and management company to facilitate record keeping and processing for the energy affiliates and has no financial value. All revenues are credited to, and all costs are borne by, the other energy affiliates with no profit element. All assets nominally in the name of HPL are held solely for the benefit of the other energy affiliates. HPL was formed as a subsidiary of the Company as a convenience and it was not intended that it have any financial impact on the Company. In the 2005 second quarter, the Company determined that its ownership of this pass-through entity created unnecessary complexity, therefore HPL was transferred for nominal consideration to officers of the energy affiliates that are not officers of the Company. The transfer was completed on May 11, 2005.

*Discontinued Operations.* The Company's real estate activities were conducted primarily through the Company's wholly owned subsidiaries. One of the subsidiaries served as the general partner of HRP, a publicly traded master limited partnership. Revenues were generated from the receipt of management fees, leasing commissions and other fees from HRP and third parties and the Company's 22% pro rata share of earnings of HRP using the equity method of accounting.

In July 2004, HRP was merged with a subsidiary of HRPT. As a result, HRP became a wholly-owned subsidiary of HRPT and was no longer a publicly traded limited partnership. The general partner interest in HRP was also sold to a HRPT subsidiary in a separate transaction and the management agreements for the properties were terminated. The Company no longer holds any interest in HRP. The Company received \$66,119,000 for its investments in HRP and related assets.

In December 2000, the Company decided to discontinue and dispose of its hotel segment, which at that time consisted of five hotel properties. Accordingly, the Company's hotel operations were reclassified as a discontinued operation. Two hotels were disposed of in 2001 and two hotels were disposed of in 2002. The Company continued to operate a leasehold interest in one hotel until December 2004, when the hotel subsidiary entered into a Lease Termination and Mutual Release Agreement. As of December 31, 2004 the Company had no further operations associated with the hotel segment.

**Presentation**

The Company intends the discussion of its financial condition and results of operations that follows to provide information that will assist in understanding its financial statements, the changes in certain key items in those financial statements from year to year, and the primary factors that accounted for those changes, as well as how certain accounting principles, policies and estimates affect its financial statements.

Following the disposition of its real estate and hotel business segments, the Company determined that its financial statements should be changed from a segmented format to a classified format; therefore, substantial reclassifications have been made to the 2004 financial statements.



**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****Results of Operations**

Income (loss) and revenue from continuing operations for the 2005 second quarter were \$(4,317,000) and \$35,857,000, respectively, compared to \$10,660,000 and \$35,554,000 in 2004. Income (loss) and revenue from continuing operations for the 2005 six month period were \$(3,411,000) and \$73,183,000, respectively, compared to \$15,978,000 and \$66,794,000 in 2004.

The Company reported income of \$2,967,000 from discontinued operations in the 2004 second quarter, and \$11,368,000 in the 2004 six month period.

The Company reported a net (loss) of \$(4,317,000) for the second quarter, compared to net income of \$13,627,000 in 2004. Net income (loss) was \$(3,411,000) and \$27,346,000 for the six month periods, respectively.

**Revenues**

Textile products sales of \$35,289,000 decreased by \$265,000, or 1%, in the 2005 second quarter, compared to \$35,554,000 in 2004. Sales for the six month period increased by \$4,890,000, or 7%, to \$71,684,000, compared to \$66,794,000 in the 2004 period. The increase for the six month period was principally due to an increase of sales of specialty fabric to U.S. military contractors. Military sales for the 2005 second quarter were \$18,158,000, of which one customer accounted for \$15,309,000, compared to \$19,621,000 and \$12,929,000 in the 2004 quarter, respectively. Military sales for the 2005 six month period totaled \$39,762,000, of which one customer accounted for \$33,485,000, compared to \$36,085,000 and \$23,494,000 in 2004, respectively.

The Company's HPL subsidiary commenced operation in October 2004 as an administrative and management company to facilitate recordkeeping and processing for the energy affiliates. All costs were rebilled to energy affiliates with no anticipated profit element. In the 2005 second quarter, the Company determined that its ownership of this pass-through entity created unnecessary complexity; therefore, HPL was transferred for nominal consideration to officers of the energy affiliates that are not officers of the Company. The transfer was completed on May 11, 2005. The administrative fees from energy affiliates were \$568,000 in the 2005 second quarter (prior to the transfer) and \$1,499,000 for the 2005 six month period.

**Expenses**

Textile products cost of sales of \$27,822,000 for the 2005 second quarter increased by \$1,981,000, or 8%, compared to \$25,841,000 in 2004. For the six months, cost of sales increased by \$6,438,000, or 13%, to \$56,502,000 from \$50,064,000 in 2004. The increases were principally due to increased sales. The reduced gross profit margin for the 2005 second quarter (21.2% versus 27.3%) and for the 2005 six month period (21.2% versus 25.0%) principally resulted from changes in product mix and increased costs, particularly energy and chemicals, offset by increased sales for the six month period.

Administrative and selling expenses were comprised of the following:

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
Corporate	\$ 7,409	\$ 756	\$ 8,853	\$ 1,298
Textile products	4,034	3,383	8,489	7,068
Energy	568		1,499	
<b>Total</b>	<b>\$ 12,011</b>	<b>\$ 4,139</b>	<b>\$ 18,841</b>	<b>\$ 8,366</b>

Corporate administrative expenses were \$7,409,000 for the 2005 second quarter, compared to \$756,000 for 2004. For the six months, corporate expenses were \$8,853,000, compared to \$1,298,000 in 2004. The increases of \$6,653,000 and \$7,555,000 in the 2005 quarter and six month periods, respectively, were primarily attributable to

bonus awards in the 2005 second quarter of \$5,000,000 to Mr. Gumbiner and \$905,000 to those officers of the Company, other than Mr. Gumbiner, who held options to purchase common stock of the Company, in lieu of amounts such option holders would have received, had they exercised their options prior to the record date of the cash distribution in partial liquidation. The 2005 period increases were also the result of increased consulting and professional fees and overhead costs.

**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Textile products administrative and selling expenses of \$4,034,000 for the 2005 second quarter increased by \$651,000, or 19%, from the 2004 amount of \$3,383,000. The increase was primarily attributable to higher payroll costs, increases in receivable reserves and losses on disposal of fixed assets, partially offset by a decline in royalties associated with the sales of fabric to military contractors. For the six months, textile expenses of \$8,489,000 increased by \$1,421,000, or 20%, from \$7,068,000 in 2004. The increase in the six month period was primarily attributable to higher royalties associated with the sales of fabric to military contractors, payroll, insurance, changes in receivable reserves and losses on disposal of fixed assets.

Administrative costs for the Company's HPL energy subsidiary, which commenced operations in October 2004, were \$568,000 in the 2005 second (prior to the transfer) quarter and \$1,499,000 for the 2005 six month period. As previously noted, HPL was transferred to two officers of the energy affiliates on May 11, 2005.

**Other Income (Loss)**

Interest and other income was \$200,000 in the 2005 second quarter and \$848,000 for the six months, compared to \$1,000 and \$3,000 in 2004. The 2005 increases were principally due to interest income earned on higher balances of cash and cash equivalents and income from investments in marketable securities.

Equity income (loss) from investments in energy affiliates, relating to the Company's pro rata share of income (loss) in the affiliates, was comprised of the following:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
HE III	\$ 516	\$	\$ 351	\$
HE II	(2)		(78)	
Hallwood Exploration	(14)	6	(79)	(4)
HEC		433		524
Total	\$ 500	\$ 439	\$ 194	\$ 520

HE III commenced commercial production and sales of natural gas in June 2004, while HE II and Hallwood Exploration remain in the development stage. As discussed in Note 18, on July 18, 2005, HE III completed a merger with Chesapeake Energy Corporation and one of its subsidiaries ( Chesapeake ), under which Chesapeake acquired HE III.

In March 2005, an agreement was entered into with a former officer of the energy affiliates, who is not otherwise affiliated with the Company, to purchase the officer's four percent profits interest in the energy affiliates for \$4,000,000, of which \$3,500,000 was ascribed to HE III and \$250,000 each to HE II and Hallwood Exploration. The purchase was settled by the energy affiliates on July 1, 2005. The energy affiliates recorded the purchase amount as compensation expense in the 2005 first quarter and the Company reflected its pro rata share, approximately \$1,100,000, as a reduction of the equity income from the energy affiliates.

In December 2004, HEC completed a merger with Chesapeake under which Chesapeake acquired HEC. Accordingly, no equity income (loss) from this investment was recorded in 2005.

Interest expense was comprised of the following:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Textile products	\$ 168	\$ 96	\$ 302	\$ 196
Corporate		295		584

Total	\$ 168	\$ 391	\$ 302	\$ 780
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**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Textile products interest expense principally relates to Brookwood's Key Bank revolving credit facility. Increases in interest expense year to year were principally due to changes in the average outstanding amounts and increasing interest rates. Corporate interest expense principally relates to the Company's former Amended and Restated Credit Agreement and 10% Debentures. The Company repaid the Amended and Restated Credit Agreement in July 2004 and redeemed the 10% Debentures in September 2004.

At December 31, 2004, the Company had recorded a receivable for \$500,000 for the anticipated additional amount the Company would receive from the disposition of its HEC investment upon final calculation of HEC's working capital. In April 2005, the Company received \$387,000 as its proportionate share of the working capital. Accordingly, the Company reduced the gain from the disposition of HEC by \$113,000 in the 2005 first quarter.

Amortization of deferred revenue of \$403,000 and \$1,007,000 in the 2004 second quarter and six month periods, respectively, was attributable to the noncompetition agreement associated with the sale of the Company's investment in Former Hallwood Energy in May 2001. Under the noncompetition agreement, the Company agreed to refrain from taking certain actions without prior consent, including, among other items, directly or indirectly engaging in certain oil and gas activities in certain geographic areas, for a period of three years. The original \$7,250,000 cash payment was amortized over a three year period which ended in May 2004.

In 1999, the Company entered into a separation agreement (the Separation Agreement) with a former officer and director and related trust. The Company had an option to extinguish certain future cash payments. In June 2004, the Company exercised the option. At which time, the Company recognized a gain from extinguishment of the Separation Agreement in the amount of \$375,000, which was the excess of the remaining obligation over the \$3,000,000 exercise price.

**Income Taxes**

Following is a schedule of income tax expense (benefit) (in thousands):

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
Continuing Operations				
Federal				
Current	\$ 650	\$ 220	\$ 656	\$ 221
Deferred	(252)	(5,206)	239	(7,891)
Sub-total	398	(4,986)	895	(7,670)
State	475	727	983	1,181
Total	\$ 873	\$ (4,259)	\$ 1,878	\$ (6,489)
Discontinued Operations				
Federal				
Current	\$	\$	\$	\$
Deferred		(2,340)		(9,642)
Sub-total		(2,340)		(9,642)

State		21		47
Total	\$	\$ (2,319)	\$	\$ (9,595)

Income tax expense in the 2005 periods includes the impact of limitations on the deductibility of executive compensation in excess of \$1,000,000 per year.

The 2004 deferred tax benefits were principally attributable to the anticipated utilization of NOLs, carryovers and tax credits that were previously reserved, to offset the gain on the sale of its general partner and limited partner interests in HRP and an increase in projected income from operations due to improved results at Brookwood and earnings from the Company's energy activities. To the extent that the elimination of the valuation allowance was attributable to the appreciation in the market value of

**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

the investments in HRP, the deferred tax benefit was allocated to discontinued operations. The state tax expense is an estimate based upon taxable income allocated to those states in which the Company does business at their respective tax rates.

During 2004, the Company utilized all of its available net operating loss carryforwards ( NOLs ), depletion carryforwards and tax credits to offset taxable income. Accordingly, at June 30, 2005, the deferred tax asset is attributable solely to temporary differences, which can be utilized to offset projected income from operations.

Although the use of such carryforwards in 2004 to offset taxable income could have been limited under certain circumstances, the Company is not aware of the occurrence of any event which would result in such limitations. In addition, utilization of NOLs in 2004 could have been limited if changes in the Company's stock ownership had created a change in control, as provided in Section 382 of the Internal Revenue Code of 1986, as amended. The Company believes no such changes occurred.

**Discontinued Real Estate Operations**

The Company's real estate business segment has been reclassified to discontinued operations as a result of the July 2004 sale of its investments in HRP and the termination of the associated management contracts.

A summary of discontinued real estate operations is provided below (in thousands):

	<b>Three Months Ended June 30, 2005</b>		<b>Six Months Ended June 30, 2005 2004</b>	
Revenues and Expenses				
Revenues				
Fees				
Related parties	\$	\$ 1,239	\$	\$ 2,413
Other		40		66
Equity income (loss) from investments in HRP		(134)		178
		1,145		2,657
Expenses				
Administrative expenses		304		536
Litigation costs		18		49
		322		585
Income before income tax		823		2,072
Income Taxes				
Deferred federal income tax benefit		(2,340)		(9,642)
Current federal and state income tax expense		21		47
		(2,319)		(9,595)
Income from discontinued real estate operations	\$	\$ 3,142	\$	\$ 11,667

*Revenues.* Fees for the 2004 periods were derived from the Company's asset management, property management, leasing and construction supervision services provided to HRP and various third parties prior to the sale of HRP in July 2004. Equity income from investments in HRP represented the Company's pro rata share of the net income reported by HRP, adjusted for the elimination of intercompany profits.

*Expenses.* Administrative expenses included salaries and related costs, office costs and leasing commissions. Litigation expense represented interest on the remaining balance due to HRP in the *Gotham Partners, L.P.* matter, in the amount of \$1,877,000, which was paid in May 2004.

The deferred tax benefit for the 2004 periods is disproportionate to income before income tax due to the recording of a deferred tax benefit attributable to the anticipated gain from the sale of the Company's investments in HRP and the related reduction in the valuation allowance.



**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****Discontinued Hotel Operations**

In December 2004, the Company's Brock Suite Huntsville, Inc. subsidiary entered into a Lease Termination and Mutual Release Agreement with the landlord of the GuestHouse Suites hotel in Huntsville, Alabama. As of December 31, 2004, the Company had no further operations in the hotel segment. Operating results for this hotel have been reclassified to discontinued operations for all periods presented.

A summary of discontinued hotel operations is provided below (in thousands):

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30, 2005</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
Revenues				
Sales	\$	\$ 380	\$	\$ 742
Expenses				
Operating expenses		520		968
Depreciation and amortization		31		62
Interest expense		3		9
Litigation and other disposition costs		1		2
		555		1,041
Loss from discontinued hotel operations	\$	\$ (175)	\$	\$ (299)

Operating expenses for the Huntsville hotel included \$269,000 and \$188,000 for lease expense and repairs and maintenance, respectively, for the 2004 six month period. Interest expense related to a capital lease obligation repaid in June 2004.

**Investment in Energy Affiliates***Hallwood Energy III, L.P.*

The Company owned approximately 28% (24% after consideration of profit interests) of HE III. The Company accounted for this investment using the equity method of accounting and recorded its pro rata share of HE III's net income (loss), partner capital transactions and comprehensive income (loss) adjustments, if any.

In 2004, the Company invested \$4,705,000 in HE III, which was formed primarily to acquire and develop oil and gas lease holdings in the Barnett Shale formation of Johnson and Hill Counties, Texas. In March 2005, the Company invested an additional \$4,251,000.

In June 2004, HE III acquired from HEC approximately 15,000 net acres of undeveloped leasehold, three proven developed non-producing natural gas properties, a limited amount of gas transmission line and various other assets. As the purchase was from a related entity, the assets were recorded at net carrying value of approximately \$4,400,000, of which the Company's proportionate share was approximately \$1,232,000. During July 2004, HE III entered into an agreement with Chesapeake, which owned approximately 12,000 net acres contiguous to that of HE III, wherein it assigned a 44% interest in its lease holdings to Chesapeake, which in turn assigned a 56% interest in its lease holdings to HE III. Under the joint operating agreement between the two entities, HE III had been designated as operator.

In December 2004, in connection with the sale of HEC, the Company, as a shareholder in HEC, received its proportionate share of debt from HE III owed to HEC in the amount of \$1,995,000, which it contributed to HE III as an additional capital investment. In addition, the Company received its proportionate share of HEC's investment in its Hallwood SWD, Inc. subsidiary, with a carrying value of approximately \$1,250,000, which was also contributed to

HE III as an additional capital investment.

HE III commenced commercial production and sales of natural gas in June 2004.

Page 10

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**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

As of July 18, 2005, HE III had drilled, acquired or was in the process of drilling 36 wells in the Barnett Shale formation in Johnson County, Texas. Twenty-four wells were producing, two wells were being drilled, eight wells were in the completion process and two wells were saltwater disposal wells. On that date, HE III held oil and gas leases covering approximately 29,000 gross and 14,000 net acres of undeveloped leasehold, predominantly in Johnson County, Texas. Natural gas production was approximately 21 million cubic feet per day, net to HE III's interest.

*Sale of HE III.* On July 18, 2005, HE III completed a merger with Chesapeake for the sale of HE III. The merger agreement provided for a total price of \$246,500,000 for all of the HE III production and reserves, as well as the operational and administrative infrastructure in Johnson County, and was subject to reduction for outstanding debt, transaction costs, changes in working capital and certain other matters. After these reductions and adjustments, Chesapeake paid a total of approximately \$235,000,000 at the closing, including debt owed by HE III, and management of HE III anticipates that an additional \$2,500,000 will be paid upon final calculation of working capital.

In exchange for its interest in HE III, the Company received a cash payment of \$54,800,000 in July 2005 and anticipates that it will receive an additional \$600,000 after calculation of HE III's working capital is completed. The Company will report the gain from the disposition of its investment in the 2005 third quarter. The Company also received a distribution for its proportionate share of certain pipe inventory owned by HE III, with a proportionate carrying value of approximately \$1,395,000, which was contributed to HE II as an additional capital investment.

Prior to the sale, HE III had four drilling rigs in operation. Three of the rigs remained with the buyer and the other rig will be utilized in connection with drilling operations at HE II.

Certain of the Company's officers and directors are investors in HE III. In addition, individual members of management of HE III, including one director and officer and one officer of the Company, hold a profit interest in HE III.

*Hallwood Energy II, L.P.*

At June 30, 2005, the Company owned approximately 24% (19% after consideration of profit interests) of HE II. It accounts for this investment using the equity method of accounting and records its pro rata share of HE II's net income (loss), partner capital transactions and comprehensive income (loss) adjustments, if any.

In September 2004, the Company invested \$2,430,000 in HE II, which was formed to explore various oil and gas exploration opportunities, primarily in Texas, and in areas not associated with HEC and HE III. In June 2005, the Company invested an additional \$1,215,000. As of August 1, 2005, HE II holds oil and gas leases covering approximately 42,000 gross and 38,000 net acres of undeveloped leasehold in Reeves, Culberson and Hill counties. HE II plans to commence drilling activities in the 2005 third and fourth quarters. Additional HE II prospects are being evaluated which may alter the current drilling schedule. HE II has one drilling rig available for operation and a second rig under construction is currently designated for drilling on HE II's leases.

In addition, the Company received a distribution for its proportionate share of certain pipe inventory owned by HE III, with a proportionate carrying value of approximately \$1,395,000, which was contributed to HE II as an additional capital investment.

In connection with the July 2005 disposition of HE III, HE II sold all of its 856 net acres lease holdings in Johnson County, Texas to Chesapeake for \$3,000,000. The Company will record its pro rata share of the gain from this transaction in the 2005 third quarter.

Certain of the Company's officers and directors are investors in HE II. In addition, individual members of management of HE II, including one director and officer and one officer of the Company, hold a profit interest in HE II.

*Hallwood Exploration, L.P.*

The Company owned approximately 20% (16% after consideration of profit interests) of Hallwood Exploration. It accounts for this investment using the equity method of accounting.

In 2004, the Company invested \$1,318,000 in Hallwood Exploration, which was formed to develop an oil and gas opportunity in South Louisiana. In June 2005, the Company invested an additional \$203,000. Hallwood Exploration

has

**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

acquired seismic lease options over approximately 36,000 acres, and is currently in the process of conducting a 3-D seismic survey over the optioned land to determine if further oil and gas exploratory activity is warranted.

Certain of the Company's officers and directors are investors in Hallwood Exploration. In addition, individual members of management of Hallwood Exploration including one director and officer and one officer of the Company, hold a profit interest in Hallwood Exploration.

*Hallwood Energy Corporation*

The Company owned approximately 28% (22% after consideration of stock options) of HEC. It accounted for the investment using the equity method of accounting and recorded its pro rata share of HEC's net income (loss), stockholders' equity transactions and comprehensive income (loss) adjustments, if any. The Company invested \$3,500,000 in HEC during 2002, \$1,997,000 in 2003, and \$566,000 in 2004.

*Sale of HEC.* In December 2004, HEC completed a merger with Chesapeake, under which Chesapeake acquired HEC. In exchange for its interest in HEC, the Company received a cash payment of \$53,793,000 in December 2004 and received an additional amount of \$387,000 in April 2005 from the settlement of HEC's working capital. The Company also received its proportionate share of the HE III debt in the amount of \$1,995,000, which it contributed to HE III as an additional capital contribution and its proportionate interest in Hallwood SWD, Inc., the former HEC subsidiary that owned the Worthington saltwater disposal well, with a carrying value of approximately \$1,250,000, which it contributed to HE III as an additional capital contribution.

Certain of the Company's officers and directors were investors in HEC. In addition, individual members of management of HEC, including one director and officer and one officer of the Company, had stock options in HEC.

**Critical Accounting Policies**

There have been no changes to the critical accounting policies identified and set forth in the Company's Form 10-K for the year ended December 31, 2004.

**Related Party Transactions**

*HRP.* The Company's real estate subsidiaries earned asset management, property management, leasing and construction supervision fees for their management of HRP's real estate properties. The management contracts with HRP, which were scheduled to expire on June 30, 2004, were amended in April 2004 to expire on the closing date of the merger with HRPT, which was completed on July 16, 2004. A summary of the fees earned from HRP is detailed below (in thousands)

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
Property management fees	\$	\$ 518	\$	\$ 995
Construction supervision fees		109		447
Leasing fees		457		663
Asset management fees		155		308
<b>Total</b>	<b>\$</b>	<b>\$ 1,239</b>	<b>\$</b>	<b>\$ 2,413</b>

Hallwood Realty was also reimbursed for certain costs and expenses, at cost, for administrative level salaries and bonuses, employee and director insurance and allocated overhead costs. In addition, since HRP did not employ any individuals, the compensation and other costs related to approximately 90 employees rendering services on behalf of HRP and its properties were reimbursed to Hallwood Realty and HCRE by HRP.

*Hallwood Investments Limited.* The Company has entered into a financial consulting contract with Hallwood Investments Limited (HIL), a corporation associated with Mr. Anthony J. Gumbiner, the Company's chairman and

principal stockholder. The contract provides for HIL to furnish and perform international consulting and advisory services to the Company and its subsidiaries, including strategic planning and merger activities, for annual compensation of \$996,000 (\$954,000 prior to March

**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

2005). Additionally, HIL and Mr. Gumbiner are also eligible for bonuses from the Company or its subsidiaries, subject to approval by the Company's or its subsidiaries' board of directors. The Company also reimburses HIL for reasonable expenses in providing office space and administrative services.

A summary of the fees and expenses related to HIL and Mr. Gumbiner are detailed below (in thousands):

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
Bonus	\$ 5,000	\$	\$ 5,000	\$
Consulting fees	249	238	491	450
Office space and administrative services	216	32	324	58
<b>Total</b>	<b>\$ 5,465</b>	<b>\$ 270</b>	<b>\$ 5,815</b>	<b>\$ 508</b>

On July 6, 2005, a special committee of the board of directors awarded Mr. Gumbiner a bonus in the amount of \$5,000,000. The amount was included in administrative and selling expense in the 2005 second quarter and paid on July 8, 2005.

In addition, HIL and Mr. Gumbiner perform services for certain affiliated entities that are not subsidiaries of the Company, for which they receive consulting fees, bonuses or other forms of compensation and expenses. The Company recognizes a proportionate share of such compensation and expenses, based upon its ownership percentage in the affiliated entities, through the utilization of the equity method of accounting.

**Contractual Obligations and Commercial Commitments**

The Company and its subsidiaries have entered into various contractual obligations and commercial commitments in the ordinary course of conducting its business operations, which are provided below as of June 30, 2005 (in thousands):

	<b>Payments Due During the Year Ending December 31,</b>						<b>Total</b>
	<b>2005*</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>Thereafter</b>	
<b>Contractual Obligations</b>							
Long term debt							
Loans payable	\$ 170	\$ 352	\$ 11,433	\$ 152	\$ 27	\$	\$ 12,134
Operating leases	410	640	223	204			1,477
<b>Total</b>	<b>\$ 580</b>	<b>\$ 992</b>	<b>\$ 11,656</b>	<b>\$ 356</b>	<b>\$ 27</b>	<b>\$</b>	<b>\$ 13,611</b>

	<b>Amount of Commitment Expiration</b>						<b>Total</b>
	<b>During the Year Ending December 31,</b>						
	<b>2005*</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>Thereafter</b>	
<b>Commercial Commitments</b>							
Employment contracts	\$ 183	\$	\$	\$	\$	\$	\$ 183

\* For the six  
months ending  
December 31,  
2005.

**Financial Covenants**

The Company's former Amended and Restated Credit Agreement and former 10% Debentures required compliance with various loan covenants and financial ratios, which, if not met, would have triggered a default. Additionally, Brookwood's Key Working Capital Credit Facility requires compliance with various loan covenants and financial ratios, principally a total debt to tangible net worth ratio and a minimum net income requirement.

*Amended and Restated Credit Agreement and 10% Debentures.* The Amended and Restated Credit Agreement and 10% Debentures were repaid in 2004. Prior to their repayment, the Company was in compliance with the covenants for both borrowings in 2004.



**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*Key Working Capital Revolving Credit Facility.* The principal ratios, as defined in the Key Working Capital Revolving Credit Facility for the last four quarters are provided below (dollar amounts in thousands):

Description	Requirement	Quarters Ended			
		June 30, 2005	March 31, 2005	December 31, 2004	September 30, 2004
Total debt to tangible net worth	must be less than 1.50	0.83	0.97	0.89	0.90
Net income	must exceed \$1	Yes	Yes	N/A	N/A
EBITDA to total fixed charges	must exceed 1.15	N/A	N/A	1.41	1.28

Brookwood was in compliance with its loan covenants under the Key Working Capital Revolving Credit Facility for the first two quarters in 2005 and for all quarters in 2004.

On March 25, 2005, Brookwood and Key Bank entered into a loan amendment which eliminated the borrowing base and certain other loan requirements, including the EBITDA to fixed charges covenant. In addition, the total debt to tangible net worth ratio covenant was reduced to 1.50 from 1.75 and a new covenant was added that Brookwood shall maintain a minimum quarterly net income of not less than \$1 beginning with the quarter ended March 31, 2005.

**Liquidity and Capital Resources**

*General.* The Company principally operates in the textile products and energy business segments. The Company's cash position decreased by \$50,951,000 during the 2005 six month period to \$20,598,000 as of June 30, 2005. The primary uses of cash were \$56,789,000 for a cash distribution in partial liquidation paid in May 2005, \$5,669,000 for investments in energy affiliates and \$1,452,000 for textile products and other equipment. The principal sources of cash were \$7,308,000 provided by operating activities, \$2,998,000 from net bank borrowings and \$2,207,000 from the exercise of stock options.

*Textiles.* The Company's textile products segment generates funds from the dyeing, laminating and finishing of fabrics and their sale to customers in the consumer, industrial, medical and military markets. Brookwood maintains a \$22,000,000 revolving line of credit facility and a \$3,000,000 equipment facility with Key Bank. The facilities have a maturity date of January 2007.

At June 30, 2005, Brookwood had approximately \$10,848,000 of unused borrowing capacity on its Key Working Capital Revolving Credit Facility and \$2,018,000 under its equipment facility. Brookwood made payments to the Company of \$2,927,000 in the 2005 six month period and \$5,373,000 in all of 2004 under its tax sharing agreement. In addition, Brookwood paid cash dividends to the Company of \$5,000,000 in the 2005 six month period and \$3,000,000 in all of 2004. Future cash dividends and tax sharing payments to the Company are contingent upon Brookwood's continued compliance with the covenants contained in the credit facility. There were no significant capital requirements as of June 30, 2005.

*Energy.* The Company has invested \$11,014,000, \$1,997,000, and \$3,500,000 in its various energy affiliates (of which \$6,063,000 was invested in HEC prior to its disposition) in 2004, 2003 and 2002, respectively, and \$5,669,000 to date in 2005. The energy affiliates anticipate that substantial additional capital will be required over the next few years to complete projected property acquisition, exploration and development costs. As a result, the Company has projected that up to \$4,000,000 may be required for additional capital investment for the remainder of 2005. The Company believes these contributions can be made from existing cash. The actual level of investment, however, will depend on a number of factors that cannot be determined at this time, including future gas prices, costs of field

operations, the ability to successfully identify and acquire prospective properties and drill and complete wells, and the availability of alternative sources of capital, such as loans from third parties.

*Sale of HE III.* On July 18, 2005, HE III completed a merger with Chesapeake. The merger agreement provided for a total price of \$246,500,000, which was subject to reduction for outstanding debt, transaction costs, changes in working capital and certain other matters. After these reductions and adjustments, Chesapeake paid a total of approximately \$235,000,000 at the closing, including debt owed by HE III, and management of HE III anticipates that an additional \$2,500,000 will be paid upon final calculation of working capital.

In exchange for its interest in HE III, the Company received a cash payment of \$54,800,000 in July 2005 and anticipates that it will receive an additional \$600,000 after calculation of HE III's working capital is completed. The Company will report the gain from the disposition of its investment in the 2005 third quarter. In addition, the Company received a distribution for its

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

proportionate share of certain pipe inventory owned by HE III, with a proportionate carrying value of approximately \$1,395,000, which was contributed to HE II as an additional capital investment.

*Additional Cash Distribution in Partial Liquidation.* On July 27, 2005, the Company announced an additional cash distribution in partial liquidation to stockholders and an equivalent bonus to option holders. The cash distribution in the amount of \$6.17 per share, totaling approximately \$9,324,000 is payable on August 18, 2005 to stockholders of record as of August 12, 2005. The distribution, along with the distribution discussed in Note 16, approximates the total amount received from the disposition of its real estate interests and partnership units. The Company held approximately \$68,000,000 in cash and marketable securities on August 12, 2005.

The Company's ability to generate cash flow from operations will depend on its future performance and its ability to successfully implement business and growth strategies. The Company's performance will also be affected by prevailing economic conditions. Many of these factors are beyond the Company's control. With the sale of HRP and HEC in 2004 and HE III in 2005 and its continuing operations, the Company believes it has sufficient funds to meet its liquidity needs.

**Forward-Looking Statements**

In the interest of providing stockholders with certain information regarding the Company's future plans and operations, certain statements set forth in this Form 10-Q relate to management's future plans, objectives and expectations. Such statements are forward-looking statements. Although any forward-looking statement expressed by or on behalf of the Company is, to the knowledge and in the judgment of the officers and directors, expected to prove true and come to pass, management is not able to predict the future with absolute certainty. Forward-looking statements involve known and unknown risks and uncertainties, which may cause the Company's actual performance and financial results in future periods to differ materially from any projection, estimate or forecasted result. Among others, these risks and uncertainties include those described in the Company's Form 10-K for the year ended December 31, 2004 in the section entitled "Business-Competition, Risks and Other Factors". These risks and uncertainties are difficult or impossible to predict accurately and many are beyond the control of the Company. Other risks and uncertainties may be described, from time to time, in the Company's periodic reports and filings with the Securities and Exchange Commission.

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES  
PART II OTHER INFORMATION**

**Item**

- 6 Exhibits
  - 31.1 Certification of the Chief Executive Officer, pursuant to Section 302 of Sarbanes-Oxley Act of 2002.
  - 31.2 Certification of the Chief Financial Officer, pursuant to Section 302 of Sarbanes-Oxley Act of 2002.
  - 32.1 Certification of Chief Executive Officer and Chief Financial Officer, pursuant to Section 906 of Sarbanes-Oxley Act of 2002.

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES  
SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**THE HALLWOOD GROUP INCORPORATED**

Dated: August 25, 2005

By: /s/ Melvin J. Melle

Melvin J. Melle, Vice President  
(Duly Authorized Officer and  
Principal Financial and  
Accounting Officer)

Page 17

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**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES  
INDEX TO EXHIBITS**

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Page 18