HALLWOOD GROUP INC
Form 10-K
April 13, 2006

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-K

MARK ONE

þ	**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
	FOR THE TRANSITION PERIOD FROM TO
	For the Year Ended December 31, 2005

Commission File Number: 1-8303
The Hallwood Group Incorporated
(Exact name of registrant as specified in its charter)

Delaware	**51-0261339**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification Number)*
3710 Rawlins, Suite 1500, Dallas, Texas	**75219**
(Address of principal executive offices)	*(Zip Code)*

Registrant s telephone number, including area code: (214) 528-5588
Securities Registered Pursuant to Section 12(b) of the Act:

Title of Class	**Name of Each Exchange on Which Registered**
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 þ NO o .

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. þ

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

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule-405 of the Securities Act. YES o NO þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES o NO þ

Indicate by check mark if the registrant is a shell company (as defined in Rule 12b-2 of the Act). YES o NO þ

The aggregate market value of the Common Stock, $0.10 par value per share, held by non-affiliates of the registrant as of June 30, 2005, based on the closing price of $85.50 per share on the American Stock Exchange, was $41,375,000.

1,511,220 shares of Common Stock, $0.10 par value per share, were outstanding at March 24, 2006.

DOCUMENTS INCORPORATED BY REFERENCE

The information called for by Part III is incorporated by reference to the definitive Proxy Statement for the Annual Meeting of Stockholders of the Company to be filed with the Securities and Exchange Commission not later than 120 days after December 31, 2005.

THE HALLWOOD GROUP INCORPORATED
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PART I

Item 1. ***Business***

The Hallwood Group Incorporated (Hallwood or the Company) (AMEX:HWG), a Delaware corporation formed in September 1981, is a holding company that operates in the textile products and energy business segments. The Company s former real estate and hotel business segments are reported as discontinued operations.

Continuing Operations

Textile Products. Textile products operations are conducted through the Company s wholly owned, Brookwood Companies Incorporated subsidiary (Brookwood). Brookwood is an integrated textile firm that develops and produces innovative fabrics and related products through specialized finishing, treating and coating processes.

Brookwood operates as a converter in the textile industry, purchasing fabric from mills that is dyed and finished and/or laminated at its own plants, or by contracting with independent finishers. Upon completion of the finishing process, the fabric is sold to customers. Brookwood, a large textile converter of nylon and some polyester fabrics, is one of the largest coaters of woven nylons in the U.S. Brookwood is known for its extensive, in-house expertise in high-tech fabric development and is a major supplier of specialty fabric to U.S. military contractors. Brookwood produces fabrics that meet standards and specifications set by both government and private industry, which are used by consumers, military and industrial customers.

Brookwood s Strategic Technical Alliance, LLC subsidiary (STA) markets advanced breathable, waterproof laminate and other fabrics primarily for military applications. Continued development of these fabrics for military, industrial and consumer applications is a key element of Brookwood s business plan.

Brookwood s Kenyon Industries, Inc. subsidiary (Kenyon) uses the latest technologies and processes in dyeing, finishing, coating and printing of woven synthetic products. At its Rhode Island manufacturing plant, Kenyon provides quality finishing services for fabrics used in a variety of markets, such as luggage and knapsacks, flag and banner, apparel, industrial, military and sailcloth.

The Brookwood Laminating, Inc. subsidiary (Brookwood Laminating) uses the latest in processing technology to provide quality laminating services for fabrics used in military clothing and equipment, sailcloth, medical equipment, industrial applications and consumer apparel. Up to five layers of textile materials can be processed using both wet and dry lamination techniques. Brookwood Laminating recently entered into a lease for manufacturing and warehouse space in Connecticut and will relocate from its Rhode Island facility during 2006.

The Brookwood Roll Goods division serves manufacturers by maintaining an extensive in-stock, short-lot service of woven nylon and polyester fabrics, offering an expansive inventory stocked in a wide array of colors. As speed is essential in this area, Brookwood Roll Goods has positioned its sales and distribution facilities in southern California and Rhode Island to allow shipment on a same day/next day basis. The First Performance Fabrics division buys and sells promotional goods, remnants and mill seconds for a vast assortment of coated and uncoated nylon products at promotional prices. Products include nylon for consumer uses, such as activewear, outerwear and swimwear as well as nylons used for balloons, luggage, bags, flags and banners. The Brookwood Roll Goods and First Performance Fabrics divisions plan to relocate their Rhode Island operations and share a portion of the Brookwood Laminating facility in Connecticut.

The textile industry historically experiences cyclical swings. Brookwood has partially offset the effect of those swings by diversifying its product lines and business base. Brookwood has historically enjoyed a fairly steady stream of orders that comprise its backlog. However, the backlog is subject to market conditions and the timing of contracts granted to its prime government contractor customers. Management believes that Brookwood maintains a level of inventory adequate to support its sales requirements and has historically enjoyed a consistent turnover ratio.

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In January 2003, Brookwood was granted a patent for its breathable, waterproof laminate and method for making same , which is a critical process in its production of specialty fabric for U.S. military contractors. Brookwood has no other patents pending. Brookwood has ongoing programs of research and development in all of its divisions adequate to maintain the exploration, development and production of innovative products and technologies.

Textile products accounts for substantially all of the Company s revenues from continuing operations.

Energy. Since January 2002, the Company has invested over $59,700,000 in its various energy affiliates, of which $6,063,000 related to Hallwood Energy Corporation (HEC) that was sold in December 2004 and $10,951,000 related to Hallwood Energy III (HE III) that was sold in July 2005. The remaining affiliates were Hallwood Energy II, L.P. (HE II), Hallwood Energy 4, L.P. (HE 4) and Hallwood Exploration, L.P. (Hallwood Exploration). The Company owned between 20% and 28% of the entities (between 16% and 22% on a fully diluted basis) and accounted for its minority investments using the equity method of accounting, recording its pro rata share of net income (loss), stockholders equity/partners capital transactions and comprehensive income (loss). Through 2005, these private companies were or have been principally involved in acquiring oil and gas leases and drilling, gathering and sale of natural gas in the Barnett Shale formation located in Johnson County, Texas and surrounding counties and the Barnett Shale and Woodford Shale formations in West Texas, conducting 3-D seismic surveys over optioned land covering a Salt Dome in South Louisiana in order to determine how best to proceed with exploratory activity and acquiring oil and gas leases in the Fayetteville Shale formation of East Arkansas.

Effective December 31, 2005, the remaining private energy affiliates, HE II, HE 4 and Hallwood Exploration were consolidated into HE 4, which was renamed Hallwood Energy, L.P. (Hallwood Energy). The Company owns approximately 26% (22% after consideration of profits interests) of Hallwood Energy.

The partners capital interests in Hallwood Energy were proportionate to the capital invested in each entity at December 31, 2005. The Company s initial investment in Hallwood Energy at December 31, 2005 was comprised of its capital contributions to each of the former private energy affiliates, as follows (in thousands):

Entity	**Amount**
HE 4	$ 22,325
HE II	14,011
Hallwood Exploration	4,624
Total	$ 40,960

All energy activities are now conducted by Hallwood Energy. Hallwood Energy s management has classified its energy investments into four identifiable areas: Delaware Basin, Texas; Fort Worth Basin, Texas; South Louisiana and East Arkansas. The following table reflects the status of Hallwood Energy s investments as of March 1, 2006:

Description	**Delaware Basin Texas(c)**	**Fort Worth Basin Texas(d)**	**South Louisiana(e)**	**East Arkansas(f)**	**Total**
Net acres held(a)(b)	43,200	1,700	35,000	270,000	349,900
Well type:					
Horizontal	2	5			7
Vertical				1	1
Well Status:					
Producing		2			2
Drilling	2	1		1	4
Completing/ Connecting		2			2

Net Production (Mcf/day)	850	850

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a) Net acres held is the sum of the total number of acres in which Hallwood Energy owns a working interest multiplied by Hallwood Energy s fractional working interest.

b) For East Arkansas, excludes in excess of 230,000 acres, which were under contract to be acquired, but for which title work has not yet been completed, some of which management believes will not ultimately be acquired.

c) Oil and gas leases in Reeves and Culberson Counties. The primary objective formations are the Barnett Shale, which appears to range in depth from 12,300 to 16,500 feet and to have a thickness of 800 to 1000 feet; and the Woodford Shale, which appears to range in depth from 13,100 to 17,500 feet and to have a thickness of 200 to 600 feet, both in Reeves and Culberson Counties.

d) Oil and gas leases in Parker and Tarrant Counties. The primary objective formation is the Barnett Shale, which appears to have a range in depth from 5,000 to 7,000 feet and to have a thickness of 200 to 400 feet.

e) Acreage was acquired to exploit a salt dome oil and gas opportunity in St. James, Ascension and Assumption Parishes. Hallwood Energy has acquired mineral lease options, has conducted and processed a 3-D seismic survey over the optioned land. Based on the results of the 3-D seismic data that have been analyzed, approximately 4,000 8,000 acres are expected to be retained for future development.

f) Oil and gas leases in nine counties. The primary objective formation is the Fayetteville Shale, which appears to range in depth from 2,700 to 7,400 feet and to have a thickness of 300 to 700 feet.

Prior to their sale, the business strategy of HEC and HE III was to identify and acquire potentially productive acreage, conduct sufficient exploratory and development drilling on the acreage to establish the acreage as productive and to develop or sell the investment to generate a favorable rate of return. The current business strategy of Hallwood Energy is similar, but management of Hallwood Energy continues to review its business strategy.

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

Refer also to Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Investments in Energy Affiliates for a further description of the Company s energy activities.

Discontinued Operations

Real Estate. The Company s real estate operations were conducted primarily through the Company s wholly owned subsidiaries, HWG, LLC, Hallwood Realty, LLC (Hallwood Realty) and Hallwood Commercial Real Estate, LLC (HCRE). Hallwood Realty was the sole general partner of Hallwood Realty Partners, L.P. (HRP), a former publicly-traded, master limited partnership.

Hallwood Realty owned a 1% general partner interest and HWG, LLC owned a 21% limited partner interest in HRP. Hallwood Realty was responsible for asset management of HRP and its properties, including the decisions regarding financing, refinancing, acquiring and disposing of properties. It also provided general operating and administrative services to HRP. HCRE was responsible for property management for all HRP properties, and properties it managed for third parties, for which it received management, leasing and construction supervision fees. Hallwood Realty and HWG, LLC accounted for their respective investments in HRP using the equity method of accounting, recording their pro rata share of net income (loss), net of an elimination for intercompany profits, comprehensive income (loss) and partners capital transactions reported by HRP.

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

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Hotels. In December 2000, the Company decided to 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 with the landlord. In connection with the lease termination, the remaining assets of the subsidiary were transferred to the landlord, and the Company obtained a release from any further obligations. As of December 31, 2004, the Company had no further operations associated with the hotel segment.

Competition, Risks and Other Factors

The Company

Influence of Significant Stockholder. The Company s chairman and chief executive officer, Mr. Anthony J. Gumbiner, owns approximately 66% of the Company s outstanding common stock (65% on a fully diluted basis) as of March 2006. Accordingly, Mr. Gumbiner can exert substantial influence over the affairs of the Company.

The Company is Dependent on its Key Personnel Whose Continued Service Is Not Guaranteed. The Company is dependent upon its executive officers for strategic business direction and specialized industry experience. While the Company believes that it could find replacements for these key personnel, loss of their services could adversely affect the Company s operations.

Textile Products

Supplier. Brookwood purchases a significant amount of the fabric and other materials it processes and sells from a small number of suppliers. Brookwood believes that the loss of any one of its suppliers would not have a long-term material adverse effect, because other manufacturers with which Brookwood conducts business would be able to fulfill those requirements. However, the loss of certain of Brookwood s suppliers could, in the short term, adversely affect Brookwood s business until alternative supply arrangements were secured. In addition, there can be no assurance that any new supply arrangements would have terms as favorable as those contained in current supply arrangements. Brookwood has not experienced any significant disruptions in supply as a result of shortages in fabrics or other materials from its suppliers.

Sales Concentration. Brookwood has one customer that accounted for more than 10% of its net sales in each of the three years ended December 31, 2005. Its relationship with the customer, Tennier Industries, Inc. (Tennier), is ongoing, and Brookwood expects to maintain comparable sales volumes with Tennier in 2006. Sales to Tennier were $56,833,000, $53,149,000 and $30,724,000 in 2005, 2004 and 2003, respectively, which represented 43%, 39% and 29% of its net sales.

Military sales, including the sales to Tennier, have generally comprised an increased portion of Brookwood s total sales and a greater share of gross profit until 2005. Military sales accounted for $72,456,000, $75,899,000 and $45,997,000 in 2005, 2004 and 2003, respectively, which represented 54%, 56% and 44% of its sales. While Brookwood has enjoyed substantial growth in its military business during the past three years, there is no assurance this trend will continue. Brookwood s sales to the customers from whom it derives its military business have been more volatile and difficult to predict, a trend the Company believes is likely to continue. In recent years, orders from the military for goods generally were significantly affected by the increased activity of the U.S. military. If this activity does not continue or declines, then orders from the military generally, including orders for Brookwood s products, may be similarly affected.

The military has recently indicated an intention to limit orders for existing products and to adopt revised specifications for new products to replace the products for which Brookwood s customers have been suppliers. While any change in specifications or orders presents a potential opportunity for additional sales, it is uncertain whether Brookwood s products will continue to comply with changing specifications as they are adopted. If Brookwood s products do not comply with the revised specifications, then it would not be able to supply those items. In addition, the U.S. government is releasing contracts for shorter periods than in the past. Therefore, the Company is unable at this time to predict future sale trends.

Concentration of Credit. The financial instruments that potentially subject Brookwood to concentration of credit risk consist principally of accounts receivable. Brookwood grants credit to customers based on an evaluation of the customer s financial condition. Exposure to losses on receivables is principally dependent on each customer s financial condition. Brookwood manages its exposure to credit risks through credit approvals, credit limits, monitoring procedures and the use of factors.

The amount of receivables that Brookwood can factor is subject to certain limitations as specified in individual factoring agreements. The factoring agreements expose Brookwood to credit risk, if any of the factors fail to meet their obligations. Brookwood seeks to manage this risk by conducting business with a number of reputable factors and monitoring the factors performance under their agreements.

Loan Covenants. Brookwood s revolving credit agreement requires compliance with various loan covenants and financial ratios, principally a total debt to tangible net worth ratio of 1.50 and a requirement that net income must exceed one dollar. Brookwood was in compliance with its loan covenants as of December 31, 2005 and all interim periods during 2005.

Environmental. Kenyon and Brookwood Laminating are subject to a broad range of federal, state and local laws and regulations relating to the pollution and protection of the environment. Among the many environmental requirements applicable to Kenyon and Brookwood Laminating are laws relating to air emissions, ozone depletion, wastewater discharges and the handling, disposal and release of solid and hazardous substances and wastes. Based on continuing internal review and advice from independent consultants, Kenyon and Brookwood Laminating believe that they are currently in substantial compliance with applicable environmental requirements. Kenyon and Brookwood Laminating are also subject to such laws as the Comprehensive Environmental Response Compensation and Liability Act (CERCLA), that may impose liability retroactively and without fault for releases or threatened releases of hazardous substances at on-site or off-site locations. Kenyon and Brookwood Laminating are not aware of any releases for which they may be liable under CERCLA or any analogous provision. Actions by federal, state and local governments concerning environmental matters could result in laws or regulations that could increase the cost of producing the products manufactured by Kenyon and Brookwood Laminating or otherwise adversely affect demand for their products. Widespread adoption of any prohibitions or restrictions could adversely affect the cost and/or the ability to produce products and thereby have a material adverse effect upon Kenyon, Brookwood Laminating or Brookwood.

Brookwood does not currently anticipate any material adverse effect on its business, results of operations, financial condition or competitive position as a result of its efforts to comply with environmental requirements. Some risk of environmental liability is inherent; however, in the nature of Brookwood s business, there can be no assurance that material environmental liabilities will not arise. It is also possible that future developments in environmental regulation could lead to material environmental compliance or cleanup costs.

Patent and Trademark. Brookwood considers its patents and trademarks, in the aggregate, to be important to its business and seeks to protect this proprietary know-how in part through U.S. patent and trademark registrations. Brookwood has a number of trademark applications pending, although no assurance can be given that trademarks will ever be issued from such applications or that any trademarks, if issued, will be determined to be valid. No assurance can be given, however, that such protection will give Brookwood any material competitive advantage. In addition, Brookwood maintains certain trade secrets for which, in order to maintain the confidentiality of such trade secrets, it has not sought patent or trademark protection and therefore such trade secrets could be infringed upon and such infringement could have a material adverse effect on its business, results of operations, financial condition or competitive position.

Competition. The cyclical nature of the textile and apparel industries, characterized by rapid shifts in fashion, consumer demand and competitive pressures, results in both price and demand volatility. The demand for any particular product varies from time to time based largely upon changes in consumer preferences and general economic conditions affecting the textile and apparel industries, such as consumer expenditures for

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non-durable goods. The textile and apparel industries are also cyclical because the supply of particular products changes as competitors enter or leave the market.

Brookwood sells primarily to domestic manufacturers, some of which operate offshore sewing operations. Some of Brookwood s customers have moved their business offshore during the past few years. Brookwood has responded by shipping fabric Asia to Asia and also by supplying finished products and garments directly to manufacturers. Brookwood competes with numerous domestic and foreign fabric manufacturers, including companies larger in size and having greater financial resources than Brookwood. The principal competitive factors in the woven fabrics markets are price, service, delivery time, quality and flexibility, with the relative importance of each factor depending upon the needs of particular customers and the specific product offering. Brookwood s management believes that Brookwood maintains its ability to compete effectively by providing its customers with a broad array of high-quality fabrics at competitive prices on a timely basis.

Brookwood s competitive position varies by product line. There are several major domestic competitors in the synthetic fabrics business, none of which dominates the market. Brookwood believes, however, that it has a strong competitive position. In addition, Brookwood believes it is one of a few finishers successful in printing camouflage on nylon for sale to apparel suppliers of the U.S. government. Additional competitive strengths of Brookwood include: knowledge of its customers business needs; its ability to produce special fabrics such as textured blends; waterproof breathable fabrics; state of the art fabric finishing equipment at its facilities; substantial vertical integration; and its ability to communicate electronically with its customers.

Imports and Worldwide Trade Practices. Imports of foreign-made textile and apparel products are a significant source of competition for most sectors of the domestic textile industry. The U.S. government has attempted to regulate the growth of certain textile and apparel imports through tariffs and bilateral agreements, which establish quotas on imports from lesser-developed countries that historically account for significant shares of U.S. imports. Despite these efforts, imported apparel, which represents the area of heaviest import penetration, is estimated to represent in excess of 90% of the U.S. market.

The U.S. textile industry has been and continues to be negatively impacted by existing worldwide trade practices, including the North American Free Trade Agreement (NAFTA), anti-dumping and duty enforcement activities by the U.S. Government and by the value of the U.S. dollar in relation to other currencies. The establishment of the World Trade Organization (WTO) in 1995 has resulted in the phase out of quotas on textiles and apparel, effective January 1, 2005. Accordingly, Brookwood believes it must fully utilize other competitive strategies to replace sales lost to importers. One strategy is to identify new market niches. 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 customers. Continued development of these fabrics for military, industrial and consumer application is a key element of Brookwood s business plan. The ongoing enterprise value of Brookwood is contingent on its ability to maintain its level of military business and adapt to the global textile industry.

In 2002, the U.S. government unveiled a proposal to eliminate worldwide tariffs for manufactured goods by 2015. The European Union has also proposed significant reductions in tariffs. These proposals have been discussed during the ongoing WTO Doha Round of multilateral negotiations, and could lead to further significant changes in worldwide tariffs beyond those already anticipated. In December 2005, the Doha Round met in Hong Kong to continue negotiations, which concluded with no major changes in direction and a consensus of continued tariff and quotas reductions.

The U.S. government engaged in discussions with a number of countries or trading blocs with the intent of further liberalizing trade. Authority to negotiate new fast track agreements has been granted by Congress, making new agreements in this field more likely. The U.S. government has also entered into a free trade agreement with Australia, Bahrain, Chile, Israel, Jordan, Morocco and Singapore.

Labor Relations. Kenyon has entered into a three-year collective bargaining agreement with the Union of Needletrades, Industrial and Textile Employees, at its Rhode Island facility, effective from March 1, 2004. Management believes that overall relations with employees are good.

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Brookwood is Dependent on its Key Personnel Whose Continued Service Is Not Guaranteed. Brookwood is dependent upon its executive officers for strategic business direction and specialized industry experience. While the Company believes that it could find replacements for these key personnel, loss of their services could adversely affect Brookwood s operations.

Energy

Energy investments may be affected by the following risk factors, each of which could adversely affect the value of the investments.

Volatility of Natural Gas Prices. A decline in natural gas prices could adversely affect financial results. Revenues, operating results, profitability, future rate of growth and the value of the natural gas properties depend primarily upon the prices received for natural gas sold. Historically, the markets for natural gas have been volatile and they are likely to continue to be volatile. Wide fluctuations in natural gas prices may result from relatively minor changes in the supply of and demand for natural gas, market uncertainty and other factors that are beyond the Company s control, including: worldwide and domestic supplies of natural gas; weather conditions; the level of consumer demand; the price and availability of alternative fuels; the availability of pipeline capacity; domestic and foreign governmental regulations and taxes; and the overall economic environment. Declines in natural gas prices would not only reduce revenue, but could reduce the amount of natural gas that can be produced economically and, as a result, could have a material adverse effect on the financial condition, results of operations and reserves for our energy affiliates.

Drilling Activities. Hallwood Energy s success is materially dependent upon the continued success of its drilling program. Future drilling activities may not be successful and, if drilling activities are unsuccessful, such failure will have an adverse effect on the Hallwood Energy s future results of operations and financial condition. Oil and gas drilling involves numerous risks, including the risk that no commercially productive oil or gas reservoirs will be encountered, even if the reserves targeted are classified as proved. The cost of drilling, completing and operating wells is often uncertain, and drilling operations may be curtailed, delayed or canceled as a result of a variety of factors, including unexpected drilling conditions, pressure or irregularities in formations, equipment failures or accidents, adverse weather conditions, compliance with governmental requirements and shortages or delays in the availability of drilling rigs and the delivery of equipment. Although numerous drilling prospects have been identified, there can be no assurance that such prospects will be drilled or that oil or natural gas will be produced from any such identified prospects or any other prospects.

Regulations. The oil and gas industry is subject to regulation at the federal, state and local level, and some of the laws, rules and regulations carry substantial penalties for noncompliance. Such regulations include requirements for permits to drill and to conduct other operations and for provision of financial assurances covering drilling and well operations.

Operations are also subject to various conservation regulations. These include the regulation of the size of drilling and spacing units and the unitization or pooling of oil or natural gas properties. In addition, state conservation laws establish maximum rates of production.

Environmental regulations concerning the discharge of contaminates into the environment, the disposal of contaminants and the protection of public health, natural resources and wildlife affect exploration, development and production operations. Under state and federal laws, the energy affiliates could be required to remove or remedy previously disposed wastes or suspend operations in contaminated areas or perform remedial plugging operations to prevent future contamination.

Competition. Hallwood Energy operates in a highly competitive area of acquisition, development and exploration of natural gas properties and production with competitors who have greater financial and other resources. Competitors from both major and independent oil and natural gas companies may be able to pay more for development prospects than the financial resources or human resources of Hallwood Energy may permit. Hallwood Energy s ability to develop and exploit natural gas properties and to acquire additional properties in the future will depend on its ability to successfully conduct operations, evaluate and select suitable properties and consummate transactions in this highly competitive environment.

Quantity and Present Value of Reserves. Financial information for the energy affiliates may contain or be based on estimates of proved reserves and the estimated future net revenues for the proved reserves. These estimates are based upon various assumptions relating to gas prices, drilling and operating expenses, capital expenditures, taxes and availability of funds. The process of estimating natural gas reserves is complex and these estimates are inherently imprecise. Actual results will most likely vary from these estimates. Actual future prices and costs may be materially higher or lower than the prices and costs as of the date of an estimate.

Environmental. Natural gas operations are subject to many environmental hazards and risks, including well blowouts, cratering and explosions, pipe failures, fires, formations with abnormal pressure, uncontrollable flows of natural gas, brine or well fluids, and other hazards and risks. Drilling operations involve risks from high pressures and mechanical difficulties such as stock pipes, collapsed casings and separated cables. If any of these risks occur, substantial losses could result from injury or loss of life, severe damages to or destruction of property, pollution or other environmental damage, clean-up responsibilities, regulatory investigations and penalties and suspension of operations. Insurance is maintained against some of these risks, but may not adequately cover all of a catastrophic loss.

Number of Employees

The Company had 462 and 514 employees as of February 28, 2006 and 2005, respectively, comprised as follows:

	February 28,	
	2006	**2005**
Hallwood	10	14
Brookwood	452	481
Hallwood Petroleum		19
Total	462	514

Kenyon has entered into a three-year collective bargaining agreement with the Union of Needletrades, Industrial and Textile Employees, representing approximately 240 employees at its Rhode Island plant facilities, effective from March 1, 2004. Management believes that overall relations with employees are good.

Available Information

The Company s Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to reports filed pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended (the Exchange Act), are available on its website at www.hallwood.com, as soon as reasonably practicable after such reports are electronically filed with the Securities and Exchange Commission. Additionally, the Company s Code of Business Conduct and Ethics, Whistle Blower Policy and Audit Committee Charter may be accessed through the website.

Executive Officers of the Company

In addition to Anthony J. Gumbiner, age 61, who serves as Director, Chairman and Chief Executive Officer, (see Item 10) the following individuals also serve as executive officers of the Company:

William L. Guzzetti, age 62, has served as President and Chief Operating Officer of the Company since March 2005 and as Executive Vice President from October 1989 to March 2005. He has also served as President, Chief Operating Officer and a Director of each of the energy affiliates since their inception. Mr. Guzzetti had served as President, Chief Operating Officer and a Director of Hallwood Energy Corporation, formerly based in Denver, Colorado and sold in May 2001 (Former Hallwood Energy) from December 1998 until May 2001 and of is predecessors since 1985. From 1990 until its sale in 2004, Mr. Guzzetti served as the President, Chief Operating Officer and a Director of Hallwood Realty and HCRE,

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respectively. He had served as the President and a director of HEC from December 2002 until December 2004. He is a member of the Florida Bar and the State Bar of Texas.

Melvin J. Melle, age 63, has served as Vice President and Chief Financial Officer of the Company since December 1984 and as Secretary of the Company since October 1987. Mr. Melle served as Assistant Secretary of the Company from December 1984 to October 1987. Mr. Melle is a member of the American Institute of Certified Public Accountants and of the Ohio Society of Certified Public Accountants.

Amber M. Brookman, age 63, has served as President, Chief Executive Officer and Director of Brookwood since 1989. Since July 2004, Ms. Brookman has served as a director of Syms Corporation, a national clothing retailer with headquarters in Secaucus, New Jersey.

Item 2. *Properties*

Real Properties

The general character, location and nature of the significant real properties owned by the Company and its subsidiaries and the encumbrances against such properties are described below.

Cost of real estate owned by property type and location as of December 31, 2005 (in thousands):

Property Type	Location	Cost
Dyeing and finishing plant	Rhode Island	$ 5,676
Parking Lot	Texas	50
Total		$ 5,726

As of December 31, 2005 no single real estate property constituted 10% or more of the Company s consolidated assets.

The textile products dyeing and finishing plant is a multi-shift facility well-suited for that particular business. The development of new products requires the plant to be constantly upgraded, along with various levels of utilization. Brookwood s Key Bank Credit Agreement contains a covenant to reasonably maintain property and equipment.

Leased Facilities

Prior to July 2004, the Company shared offices with HRP in Dallas, Texas and paid a pro-rata share of lease and other office-related costs. Thereafter, the Company assumed the lease obligation for the office space, which expires in November 2008.

Since January 2005 and August 2005, respectively, the Company shares offices with Hallwood Investments Limited (HIL), a corporation associated with Mr. Anthony J. Gumbiner, the Company s chairman, chief executive officer and principal stockholder, and Hallwood Energy, each of which pays a pro-rata share of lease and other office-related costs.

Brookwood leases its corporate headquarters in New York City which expires in August 2006. In March 2006, Brookwood entered into a second lease which will begin in the summer of 2006 for the relocation of its headquarters to another location within New York City. This ten-year lease provides for additional marketing and administrative space and has a renewal option.

Brookwood Laminating leases a facility in Peacedale, Rhode Island which expires in December 2006. It has entered into a second lease which began in January 2006 for a facility in Plainfield, Connecticut, which expires in December 2010. This lease has a five-year renewal option and a purchase option. The relocation is expected to be completed by December 2006.

Brookwood Roll Goods division leases a warehouse in Gardena, California which lease expires in April 2009.

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Item 3. ***Legal Proceedings***

Litigation. From time to time, the Company, certain of its affiliates and others have been named as defendants in lawsuits relating to various transactions in which it or its affiliated entities participated. In the Company s opinion, no litigation in which the Company, subsidiaries or affiliates is currently a party is likely to have a material adverse effect on its financial condition, results of operations or cash flows.

Gotham Partners. In June 1997, an action was filed against the Company, HRP, HRP s general partner Hallwood Realty Corporation, a predecessor entity to Hallwood Realty, LLC, and the directors of Hallwood Realty Corporation by Gotham Partners, L.P. in the Court of Chancery of the state of Delaware, styled *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., et al* (C.A. No. 15754). This action alleged claims of breach of fiduciary duties, breach of HRP s partnership agreement and fraud in connection with certain transactions involving HRP s limited partnership units in the mid 1990 s.

After a trial and appeals, the Company paid to HRP a total of $13,155,000, including interest of $6,750,000. The matter was concluded in December 2003.

High River and I.G. Holdings. In April 2003, an action was filed against HRP s general partner, Hallwood Realty (the General Partner), its directors and HRP as nominal defendant by High River Limited Partnership, which is indirectly wholly owned by Carl C. Icahn, in the Court of Chancery of the State of Delaware, styled *High River Limited Partnership v. Hallwood Realty, LLC, et al*, (C.A. No. 20276). The action related to a tender offer by High River for units of HRP. In addition, a putative class action lawsuit was filed against the General Partner, its directors and HRP as nominal defendant by three purported unitholders of HRP in the Court of Chancery of the State of Delaware, styled *I.G. Holdings, Inc., et al, v. Hallwood Realty LLC, et al*, (C.A. No. 20283) also relating to the High river tender offer.

Pursuant to a settlement agreement, HRP paid to the plaintiffs a total of $2,255,000 for attorneys fees and costs. The matter was concluded in October 2004.

Other. The Company was a defendant in two lawsuits regarding guaranties of certain obligations of the Embassy Suites and Holiday Inn hotels. In February 2003, the Company settled both matters. The Company agreed (i) to pay $150,000 in cash and issue a non-interest bearing promissory note in the amount of $250,000 payable in equal monthly installments over 18 months, in exchange for a full release regarding the Embassy Suites hotel in Oklahoma City, Oklahoma and (ii) to pay $250,000 in cash in exchange for a full release regarding the Holiday Inn hotel in Sarasota, Florida. The Company made all scheduled payments in accordance with the settlement agreements and the final payment for the aforementioned promissory note was made in December 2004.

Environmental Contingencies. A number of jurisdictions in which the Company operates have adopted laws and regulations relating to environmental matters. Such laws and regulations may require the Company to secure governmental permits and approvals and undertake measures to comply therewith. Compliance with the requirements imposed may be time-consuming and costly. While environmental considerations, by themselves, have not significantly affected the Company s business to date, it is possible that such considerations may have a significant and adverse impact in the future. The Company actively monitors its environmental compliance and while certain matters currently exist, management is not aware of any compliance issues which will significantly impact the financial position, operations or cash flows of the Company.

In October 2003, as a result of a voluntary disclosure by Brookwood Laminating, The Rhode Island Department of Environmental Management (RIDEM) issued a Notice of Violation alleging violations of the Rhode Island Air Pollution Act and seeking an administrative penalty of $379,000. Brookwood Laminating contested the penalty and received a letter from RIDEM in March 2004 proposing to reduce the penalty to $30,000, on the condition that on or before May 1, 2004 it submitted to RIDEM a proposal for the acquisition of certain environmental control equipment at a cost not less than $400,000. Brookwood Laminating submitted a proposal to RIDEM, which approved it, paid the reduced penalty and installed the equipment in July 2004.

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In August 2005, the Rhode Island Department of Health (RIDOH) issued a compliance order to Kenyon, alleging that Kenyon is a non-community water system and ordering Kenyon to comply with the RIDOH program for public water supply systems. Kenyon contested the compliance order and an administrative hearing was held in November 2005. No decision has been rendered. Complying with the RIDOH requirements would necessitate revamping of the plant s water supply system and associated costs of approximately $100,000.

In August 2005, Brookwood received a Notice of Alleged Violation from RIDEM with notification that Brookwood had failed to comply timely with a requirement to test the destruction efficiency of a thermal oxidizer at its Kenyon plant and that when the test was conducted the equipment was not operating at the required efficiency. Since that time, Brookwood has upgraded and retested the equipment, which met the requirements on the retest. RIDEM has requested additional information regarding the failed test and Brookwood s remedial actions and has indicated that a financial penalty is possible. Brookwood is cooperating with RIDEM in resolving the issue. Based on the information available to Brookwood, if a financial penalty is imposed, the Company does not believe that it will be material.

In September 2005, Brookwood accrued $250,000 for anticipated environmental remediation costs in connection with a plan to remove, dewater, transport and dispose of sludge from its lagoons. Brookwood has applied for approval with RIDEM and commenced remediation activities, which are anticipated to be completed by July 2006.

In October 2005, Brookwood Laminating received a Notice of Violation (NOV) from RIDEM alleging various violations of the Rhode Island Hazardous Waste Management Program and seeking an administrative penalty of approximately $20,000. Brookwood Laminating is contesting the NOV and is currently engaged in settlement negotiations with RIDEM.

Item 4. *Submission of Matters to a Vote of Security Holders*

No matters were submitted to a vote of security holders during the period.

PART II

Item 5. *Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities*

The Company s shares of common stock, $0.10 par value per share (the Common Stock), are traded on the American Stock Exchange under the symbol of HWG. There were 611 stockholders of record as of March 24, 2006.

The following table sets forth a two-year record, by quarter, of high and low closing prices on the American Stock Exchange and cash dividends paid.

	Years Ended December 31,					
	2005			2004		
Quarters	**High**	**Low**	**Dividends**	**High**	**Low**	**Dividends**
First	$ 141.98	$ 99.25	$	$ 39.30	$ 19.20	$
Second	159.00	73.00	37.70	51.00	28.00	
Third	90.00	61.00	6.17	85.75	43.50	
Fourth	81.00	56.50		120.50	82.05	

During 2005, the Company paid two cash dividends. The first dividend in the amount of $37.70 per share was paid on May 27, 2005 to stockholders of record as of May 20, 2005. The second dividend in the amount of $6.17 per share was paid on August 18, 2005 to stockholders of record as of August 12, 2005.

The closing price per share of the Common Stock on the American Stock Exchange on March 24, 2006 was $136.25.

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Item 6. ***Selected Financial Data***

	Years Ended December 31,				
	2005	2004	2003	2002	2001
	(In thousands, except per share data)				
Revenues	$ 134,607	$ 137,280	$ 104,720	$ 84,770	$ 68,894
Expenses	134,554	125,609	100,145	84,702	71,383
Operating income (loss)	53	11,671	4,575		