

HALLWOOD GROUP INC

Form 10-Q

June 05, 2007

Table of Contents

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

Form 10-Q

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 March 31, 2007

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:

Title of Class

Common Stock (\$0.10 par value)

Name of Each Exchange On Which Registered

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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

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

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

1,516,711 shares of Common Stock, \$0.10 par value per share, were outstanding at April 30, 2007.

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

ITEM NO.		PAGE
PART I FINANCIAL INFORMATION		
1	Financial Statements (Unaudited):	
	<u>Condensed Consolidated Balance Sheets as of March 31, 2007 and December 31, 2006</u>	3
	<u>Condensed Consolidated Statements of Operations for the Three Months Ended March 31, 2007 and 2006</u>	4
	<u>Condensed Consolidated Statements of Comprehensive Income (Loss) for the Three Months Ended March 31, 2007 and 2006</u>	5
	<u>Condensed Consolidated Statement of Changes in Stockholders' Equity for the Three Months Ended March 31, 2007</u>	6
	<u>Condensed Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2007 and 2006</u>	7
	<u>Notes to Condensed Consolidated Financial Statements</u>	8
2	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	18
3	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	29
4	<u>Controls and Procedures</u>	30
<u>PART II OTHER INFORMATION</u>		
<u>1 thru 6</u>	<u>Other Information</u>	31
	<u>Signature Page</u>	32
	<u>Index to Exhibits</u>	33
	<u>Certification of CEO Pursuant to Section 302</u>	
	<u>Certification of CFO Pursuant to Section 302</u>	
	<u>Certification of CEO and CFO Pursuant to Section 906</u>	

Table of Contents**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS****(dollars in thousands)****(unaudited)**

	March 31, 2007	December 31, 2006
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 5,884	\$ 10,054
Accounts receivable, net		
Trade and other	21,228	19,623
Related parties	80	161
Inventories, net	17,369	17,293
Prepaid federal income taxes	3,861	3,861
Deferred income tax, net	995	904
Prepays, deposits and other assets	875	916
	50,292	52,812
Noncurrent Assets		
Investments in Hallwood Energy, L.P.	34,363	39,864
Property, plant and equipment, net	13,826	13,853
Deferred income tax, net	4,576	751
Other assets	192	317
	52,957	54,785
Total Assets	\$ 103,249	\$ 107,597

LIABILITIES AND STOCKHOLDERS EQUITY

Current Liabilities		
Accounts payable	\$ 9,835	\$ 10,491
Accrued expenses and other current liabilities	3,739	3,217
Current portion of loans payable	238	275
Income taxes payable	32	31
	13,844	14,014
Noncurrent Liabilities		
Long term portion of loans payable	13,817	10,617
Redeemable preferred stock	1,000	1,000
	14,817	11,617

Total Liabilities	28,661	25,631
Stockholders Equity		
Common stock, issued 2,396,105 for both periods; outstanding 1,516,711 and 1,515,438 shares, respectively	240	240
Additional paid-in capital	56,531	56,451
Accumulated other comprehensive income		55
Retained earnings	31,077	38,401
Treasury stock, 879,394 and 880,667 shares, respectively; at cost	(13,260)	(13,181)
Total Stockholders Equity	74,588	81,966
Total Liabilities and Stockholders Equity	\$ 103,249	\$ 107,597

See accompanying notes to condensed consolidated financial statements.

Page 3

Table of Contents**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(in thousands, except per share amounts)****(unaudited)**

	Three Months Ended March 31,	
	2007	2006
Revenues		
Textile products sales	\$ 28,308	\$ 30,775
Expenses		
Textile products cost of sales	24,289	24,819
Administrative and selling expenses	4,604	4,650
	28,893	29,469
Operating income (loss)	(585)	1,306
Other Income (Loss)		
Investments in Hallwood Energy, L.P.		
Equity loss	(10,503)	(350)
Interest income	12	
Interest expense	(226)	(117)
Interest and other income	181	108
	(10,536)	(359)
Income (loss) before income taxes	(11,121)	947
Income tax expense (benefit)	(3,797)	483
Net Income (Loss)	\$ (7,324)	\$ 464
Net Income (Loss) Per Common Share		
Basic	\$ (4.83)	\$ 0.31
Assuming dilution	\$ (4.83)	\$ 0.30
Weighted Average Shares Outstanding		
Basic	1,517	1,511

Assuming dilution

1,517

1,523

See accompanying notes to condensed consolidated financial statements.

Page 4

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(In thousands)
(unaudited)

	Three Months Ended	
	March 31,	
	2007	2006
Net Income (Loss)	\$ (7,324)	\$ 464
Other Comprehensive Income (Loss)		
Previously realized increase in fair value of marketable securities sold during the period	(55)	
Comprehensive Income (Loss)	\$ (7,379)	\$ 464

See accompanying notes to condensed consolidated financial statements.

Page 5

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY
(in thousands)
(unaudited)

	Common Stock Shares	Par Value	Additional Paid-In Capital	Retained Earnings	Accumulated Compre- hensive Income	Treasury Stock Shares	Cost	Total Stockholders Equity
Balance, January 1, 2007	2,396	\$ 240	\$ 56,451	\$ 38,401	\$ 55	881	\$(13,181)	\$ 81,966
Net loss				(7,324)				(7,324)
Previously realized increase in fair value of marketable securities sold during the period					(55)			(55)
Reissuance of treasury shares from exercise of stock options and related income tax effect			80			(3)	34	114
Purchase of common stock for treasury						1	(113)	(113)
Balance, March 31, 2007	2,396	\$ 240	\$ 56,531	\$ 31,077	\$	879	\$(13,260)	\$ 74,588

See accompanying notes to condensed consolidated financial statements.

Page 6

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Three Months Ended	
	March 31,	
	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	\$ (7,324)	\$ 464
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:		
Depreciation and amortization	509	471
Equity loss from investments in Hallwood Energy, L.P.	10,503	350
Deferred tax expense (benefit)	(3,836)	250
Excess tax benefits from share-based payment arrangements	(80)	
Proceeds from sale of marketable securities	148	
Income from investments in marketable securities	(74)	
Changes in assets and liabilities:		
Increase (decrease) in income taxes receivable/payable	(17)	101
(Increase) decrease in accounts receivable	(1,524)	(870)
Increase (decrease) in accounts payable	(763)	2,760
Increase (decrease) in accrued expenses and other current liabilities	522	(894)
(Increase) decrease in inventories	(76)	(1,589)
Net change in other assets and liabilities	55	(23)
Net cash (used in) provided by operating activities	(1,957)	1,020
CASH FLOWS FROM INVESTING ACTIVITIES		
Investments in and loans to Hallwood Energy, L.P.	(5,002)	(2,721)
Investments in property, plant and equipment	(375)	(723)
Net cash used in investing activities	(5,377)	(3,444)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from revolving credit facilities, net	3,254	902
Repayment of other bank borrowings and loans payable	(91)	(86)
Proceeds from exercise of stock options	34	
Purchase of common stock for treasury	(113)	
Excess tax benefits from share-based payment arrangements	80	
Net cash provided by financing activities	3,164	816
DECREASE IN CASH AND CASH EQUIVALENTS	(4,170)	(1,608)

CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	10,054	16,648
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 5,884	\$ 15,040

See accompanying notes to condensed consolidated financial statements.

Page 7

Table of Contents

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Three Months Ended March 31, 2007 and 2006
(unaudited)**

**Note 1 Interim Condensed Consolidated Financial Statements, Accounting Policies and
New Accounting Pronouncements**

Interim Condensed Consolidated Financial Statements. The interim condensed consolidated financial statements of The Hallwood Group Incorporated and its subsidiaries (the Company) (AMEX: HWG) have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and disclosures required by accounting principles generally accepted in the United States of America. Although condensed, in the opinion of management, all adjustments considered necessary for a fair presentation have been included. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related disclosures thereto included in Form 10-K for the year ended December 31, 2006.

Organization. The Company is a holding company that currently operates in the textile products and energy business segments.

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's subsidiary, Strategic Technical Alliance, LLC (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.

Textile products accounts for substantially all of the Company's operating revenues.

Energy. Prior to December 31, 2005, the Company had investments in Hallwood Energy Corporation (HEC), which was sold in December 2004 and Hallwood Energy III, L.P. (HE III), which was sold in July 2005, 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 the investments using the equity method of accounting, recording its pro rata share of net income (loss), stockholders' equity/partners' capital transaction and comprehensive income (loss).

Effective December 31, 2005, HE II and Hallwood Exploration were consolidated into HE 4, which was renamed Hallwood Energy, L.P. (Hallwood Energy). At the consolidation date, Hallwood Energy was principally involved in acquiring oil and gas leases and drilling, gathering and sale of natural gas in the Barnett Shale formation located in Parker, Hood and Tarrant Counties in North Texas and the Barnett Shale and Woodford Shale formations in Reeves and Culberson Counties in West Texas and in the Fayetteville Shale formation of Central Eastern Arkansas, and 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.

Following the completion of the energy consolidation on December 31, 2005, all energy activities are conducted by Hallwood Energy. Subsequent to the July 2006 sale of its properties in North Texas (discussed below), Hallwood Energy's management has classified its energy investments into three identifiable areas: Central Eastern Arkansas, South Louisiana and West Texas.

In June 2006, Hallwood Energy completed the sale of a 60% undivided working interest in its oil and gas properties in Reeves and Culberson Counties in West Texas and all of its interest in the properties in Parker, Hood and Tarrant Counties in North Texas to Chesapeake Energy Corporation (Chesapeake). Chesapeake assumed operation of these properties. See Note 3.

At March 31, 2007, the Company owned approximately 25% (20% after consideration of profit interests) of Hallwood Energy.

New Accounting Pronouncements.

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). The Company adopted the provisions of FIN 48 on January 1, 2007. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in

accordance with FASB Statement No. 109, *Accounting for Income Taxes*, and prescribes a recognition threshold and measurement process for financial

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Three Months Ended March 31, 2007 and 2006
(unaudited)

statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

The Company has completed its evaluation and has determined that there are no significant uncertain tax positions requiring recognition in its consolidated financial statements. The evaluation was performed for the tax years ended December 31, 2003, 2004, 2005 and 2006, the tax years which remain subject to examination by major tax jurisdictions as of March 31, 2007. The Company does not believe there will be any material changes in its unrecognized tax positions over the next 12 months.

The Company may from time to time be assessed interest or penalties by major tax jurisdictions, although any such assessments historically have been minimal and immaterial to its financial results. In the event the Company incurs interest and/or penalties, they will be classified in the financial statements as interest expense or administrative and selling expense, respectively.

Note 2 Inventories

Inventories as of the balance sheet dates were as follows (in thousands):

	March 31, 2007	December 31, 2006
Raw materials	\$ 5,477	\$ 5,590
Work in progress	1,858	4,300
Finished goods	10,831	8,260
	18,166	18,150
Less: Obsolescence reserve	(797)	(857)
Total	\$ 17,369	\$ 17,293

Note 3 Investments in and Loans to Hallwood Energy, L.P.

Investments in and loans to Hallwood Energy as of the balance sheet dates were as follows (in thousands):

Description	Cost as of March 31, 2007	Amount at which carried at		Income (loss) for the three months ended	
		March 31, 2007	December 31, 2006	March 31, 2007	2006
- Limited partner interest	\$ 50,383	\$ 29,359	\$ 39,859	\$(10,502)	\$ (349)
- General partner interest	6	4	5	(1)	(1)
- Loans	5,000	5,000			
Total	\$ 55,389	\$ 34,363	\$ 39,864	\$(10,503)	\$ (350)

At March 31, 2007, the Company owned approximately 25% (20% after consideration of profit interests) of Hallwood Energy. The Company accounts for this investment using the equity method of accounting and records its pro rata share of Hallwood Energy's net income (loss) and partner capital transactions.

Hallwood Energy is an upstream energy partnership engaging in the acquisition, development, exploration, production, and sale of hydrocarbons, with a primary focus on natural gas assets. Hallwood Energy's results of operations are and will be largely dependent on a variety of variable factors, including, but not limited to fluctuations in natural gas prices; success of its exploratory drilling activities; the ability to transport and sell its natural gas; regional and national regulatory matters; and the ability to secure, and price of, goods and services necessary to develop its oil and gas leases.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Three Months Ended March 31, 2007 and 2006
(unaudited)

In July 2006, Hallwood Energy completed the sale of a 60% undivided working interest in its oil and gas properties in Reeves and Culberson Counties in West Texas and all of its interest in the properties in Parker, Hood and Tarrant Counties in North Texas to Chesapeake. Chesapeake assumed operation of these properties. Following the July 2006 sale, Hallwood Energy's management classified its energy investments into three identifiable areas: Delaware Basin, Texas; South Louisiana and East Arkansas.

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.

A description of Hallwood Energy's activities during 2007 are provided below.

Loan Financing. In February 2006, Hallwood Energy entered into a \$65,000,000 loan facility, and had drawn \$40,000,000 as of December 31, 2006. Subsequent to December 31, 2006, Hallwood Energy was not in compliance with the proved collateral coverage ratio.

In March 2007 and April 2007, the Company advanced \$5,000,000 and \$4,000,000, respectively, to Hallwood Energy, of which \$7,000,000 was in the form of demand notes bearing interest at 6% above prime rate, and \$2,000,000 was an advance that was repaid four days later with interest. In April 2007, Hallwood Energy made a request for additional capital contributions in the amount of \$25,000,000 (the April Call). The Company and Hallwood Energy had agreed that the \$7,000,000 amount previously advanced would be applied as the Company's portion of this capital call. On May 10, 2007, Hallwood Energy repaid \$257,000 to the Company, which represented the excess of the \$7,000,000 advanced over the Company's share of the capital contribution and related oversubscription.

In April 2007, Hallwood Energy entered into a \$100,000,000 senior secured credit facility (the Credit Facility) with an affiliate of one of the investors and drew \$65,000,000 from the Credit Facility. The proceeds were used to repay \$40,000,000 in an existing note payable, pay approximately \$9,800,000 for a make-whole fee and incremental interest of approximately \$500,000 to the original lender related to the \$40,000,000 note payable, and transaction fees of approximately \$200,000. Borrowings under the Credit Facility are secured by Hallwood Energy's oil and gas leases, mature on February 1, 2010, and bear interest at a rate of the defined LIBOR rate plus 10.75% per annum. An additional 2% of interest is added upon continuance of any defaulting event. The new lender may demand that Hallwood Energy prepay the outstanding loans in the event of a defined change of control, qualified sale or event of default, including a material adverse event. In conjunction with executing the Credit Facility, the new lender resigned its position on the board of directors and assigned its general partner interest to the remaining members.

Provided that Hallwood Energy raises \$25,000,000 through an equity call or through debt subordinate to the Credit Facility (discussed below), the new lender will match subsequent amounts raised on a dollar for dollar basis up to the remaining \$35,000,000 under the Credit Facility through the availability termination date of July 31, 2008. Hallwood Energy successfully completed the \$25,000,000 April Call in May 2007, of which the Company contributed \$6,743,000.

The Credit Facility contains various financial covenants, including maximum general and administrative expenditures and current and proved collateral coverage ratios. The proved collateral coverage ratio is effective June 30, 2008. Non-financial covenants restrict the ability of Hallwood Energy to dispose of assets, incur additional indebtedness, prepay other indebtedness or amend certain debt instruments, pay dividends, create liens on assets, enter into sale and leaseback transactions, make investments, loans or advances, make acquisitions, engage in mergers or consolidations or engage in certain transactions with affiliates, and otherwise restrict certain activities by Hallwood Energy.

The Credit Facility contains a make-whole provision whereby Hallwood Energy is required to pay the lender the amount by which the present value of interest and principal from the date of prepayment through January 31, 2009, exceeds the principal amount on the prepayment date. The lender received warrants exercisable for 2.5% of the

partnership interests at an exercise price of 2.5% of 125% of the amount of the total capital contributed to Hallwood Energy at December 31, 2006.

Equity Investments. In November 2006, Hallwood Energy requested an additional capital contribution in the amount of \$25,000,000 from its partners. The Company invested an additional \$6,281,000 to maintain its proportionate interest in Hallwood Energy. The Company utilized a \$452,000 capital contribution receivable to reduce its cash contribution to \$5,829,000. In addition, certain other investors in Hallwood Energy did not elect to fund their proportionate interest of the additional capital contribution; therefore, in December 2006, the Company invested an additional \$425,000 and \$2,000 in January 2007 in excess of its proportionate interest. These contributions were made from existing cash.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Three Months Ended March 31, 2007 and 2006
(unaudited)

Hallwood Energy issued the \$25,000,000 April Call to its partners on April 14, 2007. Previously, Hallwood Energy received cash advances of \$7,000,000 each from the Company and an affiliate of the new lender. These advances were applied to the April Call. In May, Hallwood Energy repaid \$257,000 to the Company, which represented the excess of the \$7,000,000 advanced over the Company's share of the capital contribution and related oversubscription.

Hallwood Energy issued a \$20,000,000 equity call to its partners on May 21, 2007 (the May Call), which is due on July 1, 2007. The Company's proportionate share of the equity call is \$5,091,000. The Company currently intends to fund approximately \$2,500,000 of the May Call, but does not have funds available to contribute substantial additional capital in connection with that or future calls.

For the funds received as a result of the April Call and the May Call, Hallwood Energy issued or will issue preferred partnership interests that will have a preferential right to any distributions made by Hallwood Energy from operations or upon liquidation. The preferential right will be equal to the amount of the capital contributed with respect to the preferred interest plus 16% per annum, compounded monthly. The preferred interests will receive this priority return before any amounts are paid to the common interests issued for all previous investments in Hallwood Energy. The capital contributed plus the accumulated 16% return attributable to any preferred interest is also convertible to common partnership interests at any time at a price equal to the price of the common partnership interests at December 31, 2006. Distributions on the preferred partnership interests will initially be accrued and become payable when, as and if declared by the general partner of Hallwood Energy. Hallwood Energy does not anticipate paying any distributions in the foreseeable future.

In April 2007, Hallwood Investments Limited (HIL), a corporation associated with Mr. Anthony J. Gumbiner the Company's chairman and principal stockholder, and the new lender have each committed to fund one-half of the April Call and potential additional equity or subordinated debt funding calls totaling \$55,000,000 by Hallwood Energy, to the extent other investors, including the Company, do not respond to a call. Pursuant to this commitment, HIL intends to fund that portion of the May Call that the Company does not fund. The Company and Mr. Gumbiner have agreed to discuss in the future the terms on which HIL will make this funding as between the Company and HIL.

Litigation. In early 2006, Hallwood Energy entered into two two-year contracts with Eagle Drilling, LLC (subsequently Eagle Drilling Operations, LLC), under which the contractor was to provide drilling rigs and crews to drill wells in Arkansas at a daily rate of \$18,500, plus certain expenses for each rig. In August 2006, one of the rigs provided by the contractor collapsed. Hallwood Energy requested the contractor to provide assurances that the other rig, and any rig provided to replace the collapsed rig, were safe and met the requirements of the contracts. When the contractor refused to provide these assurances, Hallwood Energy notified the contractor that the contracts were terminated and on September 6, 2006, filed *Hallwood Petroleum, LLC and Hallwood Energy, L.P. v. Eagle Drilling, LLC and Eagle Domestic Drilling Operations, LLC*, in the 348th District Court of Tarrant County, Texas to recover approximately \$1,688,000 previously deposited with the contractor under the contracts. Eagle Domestic Drilling Operations, LLC has asserted damages in excess of \$22,000,000 against Hallwood Energy, principally for breach of contract. Eagle Domestic Drilling Operations, LLC and its parent have since filed for Chapter 11 bankruptcy protection. Hallwood Energy is currently unable to determine the impact of this matter on its results of operations and financial position.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Three Months Ended March 31, 2007 and 2006
(unaudited)

The following table sets forth summarized financial data for Hallwood Energy, L.P. (in thousands):

	March 31, 2007	December 31, 2006
Balance Sheet Data		
Cash and cash equivalents	\$ 1,909	\$ 25,978
Oil and gas properties, net	186,305	179,986
Total assets	201,443	214,362
Loans payable	49,019	39,019
Total liabilities	83,088	54,209
Partners capital	118,355	160,153
	Three Months Ended March 31, 2007	2006
Statement of Operations Data		
Revenues		
Natural gas sales	\$	\$ 383
Expenses		
Impairment of oil and gas properties	31,680	
General and administrative expenses	1,659	1,111
Operating expenses	4	297
Depreciation and depletion	63	199
	33,406	1,607
Operating Loss	(33,406)	(1,224)
Other Income and Expense		
Interest expense	(8,527)	(720)
Interest income	134	621
	(8,393)	(99)
Net Loss	\$ (41,799)	\$ (1,323)

Note 4 Loans Payable

Loans payable at the balance sheet dates were as follows (in thousands):

	March 31, 2007	December 31, 2006
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Bank debt		
Revolving credit facility, interest at Libor +1.25% - 1.75% or prime, due January 2010	\$ 13,686	\$ 10,432
Equipment term loans, interest at various rates; due at various dates through February 2009	369	460
Total	14,055	10,892
Current portion	(238)	(275)
Noncurrent portion	\$ 13,817	\$ 10,617

Revolving Credit Facility. The Company's Brookwood subsidiary has a revolving credit facility in an amount up to \$22,000,000 with Key Bank National Association (the Key Working Capital Revolving Credit Facility). Borrowings are collateralized by accounts receivable, certain finished goods inventory, machinery and equipment and all of the issued and outstanding capital stock of Brookwood and its subsidiaries. The facility (after the renewal discussed below) bears interest at Brookwood's option of Prime, or Libor plus 1.25% - 1.75% (variable depending on compliance ratios) and contains various

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Three Months Ended March 31, 2007 and 2006
(unaudited)

covenants. The interest rate was a blended rate of 7.21% and 7.16% at March 31, 2007 and December 31, 2006, respectively. The outstanding balance at March 31, 2007 was \$13,686,000 and Brookwood had approximately \$8,314,000 of borrowing availability under this facility.

Equipment Term Loans. Brookwood has a revolving equipment credit facility in an amount up to \$3,000,000 with Key Bank. Interest rates for the equipment loans varied between 5.60% and 8.60%, with a blended rate of 7.02% and 7.17% at March 31, 2007 and December 31, 2006, respectively. The outstanding balance at March 31, 2007 was \$369,000 and Brookwood had \$2,631,000 of borrowing availability under this facility.

Loan Covenants. As of the end of the first quarter in 2007 and all of the quarters in 2006, Brookwood was in compliance with its loan covenants. The Key Working Capital Revolving Credit Facility provides for a total debt to tangible net worth ratio covenant and a covenant that Brookwood shall maintain a quarterly minimum net income of not less than one dollar. Cash dividends and tax sharing payments to the Company are contingent upon Brookwood's compliance with the covenants contained in the loan agreement.

Renewal of Credit Facilities. Both of the Key Bank facilities, which had original maturities of January 2007, were renewed in March 2006 for a period of three years with a new maturity of January 30, 2010. The amounts of the respective facilities and the loan covenants were unchanged; however, the interest rate on the Key Working Capital Revolving Credit Facility was reduced, at Brookwood's option, from Prime plus 0.25% or Libor plus 1.75% to 3.00% (variable depending on compliance ratios).

Note 5 Stockholders Equity

Stock Options. The Company established the 1995 Stock Option Plan for The Hallwood Group Incorporated which authorized the granting of nonqualified stock options to employees, directors and consultants of the Company. The 1995 Plan authorized options to purchase up to 244,800 shares of common stock of the Company. The exercise prices of all options granted were at the fair market value of the Company's stock on the date of grant, had an expiration date of ten years from date of grant and were fully vested on the date of grant.

At March 31, 2007, the Company had 12,000 fully vested outstanding options, of which 7,500 expire in September 2007 and 4,500 expire in May 2010. The 1995 Stock Option Plan terminated on June 27, 2005. Options issued prior to the termination are not affected, however, no new options can be issued under the 1995 Plan.

In January 2007, one officer of the Company exercised options to purchase 2,250 shares of the Company's common stock that were scheduled to expire in February 2007. The officer paid the exercise price and related tax withholding requirement by exchanging an equivalent number of common shares valued at the fair market value of the common stock at the time of exercise. The net result of the exercise and exchange was the issuance of 1,273 shares from treasury at an average carrying value of \$14.97 per share.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Three Months Ended March 31, 2007 and 2006
(unaudited)

Option activity for the quarter ended March 31, 2007 and status of outstanding options are as follows:

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding, January 1, 2007	14,250	\$ 14.77		
Granted				
Exercised	(2,250)	15.00		
Forfeited				
Outstanding, March 31, 2007	12,000	\$ 14.72	1.45	\$ 1,077,000
Options exercisable at March 31, 2007	12,000		1.45	\$ 1,077,000
Options vested at March 31, 2007	12,000		1.45	\$ 1,077,000

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company's closing stock price on the last trading day of the 2007 first quarter and the exercise price, multiplied by the number of options). The intrinsic value of the options exercised during the 2007 first quarter was approximately \$226,000.

Note 6 Income Taxes

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

	Three Months Ended March 31,	
	2007	2006
Federal		
Current	\$	\$
Deferred	(3,794)	250
Sub-total	(3,794)	250
State		
Current	40	233
Deferred	(43)	
Sub-total	(3)	233

Total	\$ (3,797)	\$ 483
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The net deferred tax asset was \$5,571,000 and \$1,655,000 at March 31, 2007 and December 31, 2006, respectively. The deferred tax asset was comprised of projected taxable losses that can be carried back for a refund, temporary differences, that upon reversal, can be utilized to offset income from operations and \$531,000 of alternative minimum tax credits. The effective federal tax rate in both periods was 34%, while state taxes were determined based upon taxable income apportioned to those states in which the Company does business at their respective tax rates.

Prepaid federal income taxes, attributable to the anticipated carryback of its 2006 taxable loss was \$3,861,000 at March 31, 2007 and December 31, 2006. The Company filed an application for tentative refund with the Internal Revenue Service in March 2007 and received a \$1,000,000 refund in April 2007. The Company expects to file a carryback of its 2006 taxable loss to obtain an additional refund in September 2007.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Three Months Ended March 31, 2007 and 2006
(unaudited)

Note 7 Supplemental Disclosures to the Condensed Consolidated Statements of Cash Flows

The following transactions affected recognized assets or liabilities but did not result in cash receipts or cash payments (in thousands):

Supplemental schedule of non-cash investing and financing activities:

Description	Three Months Ended March 31,	
	2007	2006
Income tax effect from exercise of stock options:		
Income taxes payable	\$ 80	\$
Additional paid-in capital	(80)	
	\$	\$
Change in accrued capital expenditures in accounts payable	\$ 107	\$
Previously realized increase in fair value of marketable securities sold during the period	\$ (55)	\$

Supplemental disclosures of cash payments:

Description	Three Months Ended March 31,	
	2007	2006
Income taxes paid	\$ 65	\$131
Interest paid	204	182

Note 8 Computation of Income (Loss) Per Common Share

The following table reconciles weighted average shares outstanding from basic to assuming dilution and reconciles the Company's net income (loss) used in the computation of income (loss) per share for the basic and assuming dilution methods (in thousands):

Description	Three Months Ended March 31,	
	2007	2006
Weighted Average Shares Outstanding		
Basic	1,517	1,511
Potential shares from assumed exercise of stock options		19
Potential repurchase of shares from stock option proceeds		(7)
Assuming dilution	1,517	1,523

Net Income (Loss)

Basic and assuming dilution

\$ (7,324)

\$ 464

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Three Months Ended March 31, 2007 and 2006
(unaudited)

Due to the loss for the three months ended March 31, 2007, potential shares from assumed exercise of stock options in the amount of 7,000 shares were antidilutive.

Note 9 Litigation, Contingencies and Commitments

Reference is made to Note 20 to the consolidated financial statements contained in Form 10-K for the year ended December 31, 2006.

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 a party is likely to have a material adverse effect on its financial condition, results of operation or cash flows.

Hallwood Energy. As a significant investor in Hallwood Energy, the Company may be impacted by litigation involving Hallwood Energy. Refer to Note 3 for a further description of certain litigation involving Hallwood Energy.

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 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 The Rhode Island Department of Environmental Management (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, which Kenyon has provided. In February 2007, RIDEM issued a Notice of Violation (NOV) accompanied by a \$14,000 fine. Kenyon requested an informal hearing to dispute the allegations in the NOV and the fine. As a result of the informal hearing held on March 30, 2007, a consent agreement was executed and a \$9,500 fine was remitted to RIDEM to close this matter.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Three Months Ended March 31, 2007 and 2006
(unaudited)

Note 10 Segments and Related Information

The following represents the Company's reportable segment operations for the three months ended March 31, 2007 and 2006, respectively (in thousands):

	Textile Products	Energy	Other	Consolidated
Three months ended March 31, 2007				
Total revenue from external sources	\$ 28,308			\$ 28,308
Operating income (loss)	\$ 498	\$	\$ (1,083)	\$ (585)
Other income (loss), net	(226)	(10,491)	181	(10,536)
Income (loss) before income taxes	\$ 272	\$ (10,491)	\$ (902)	\$ (11,121)
Three months ended March 31, 2006				
Total revenue from external sources	\$ 30,775			\$ 30,775
Operating income (loss)	\$ 2,475	\$	\$ (1,169)	\$ 1,306
Other income (loss), net	(117)	(350)	108	(359)
Income (loss) before income taxes	\$ 2,358	\$ (350)	\$ (1,061)	\$ 947

No differences have occurred in the basis or methodologies used in the preparation of this interim segment information from those used in the December 31, 2006 annual report. The total assets for the Company's operating segments have not materially changed since the December 31, 2006 annual report.

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. The Company is a holding company with interests in textiles and energy. Although the Company's textile activities have generated positive cash flow in recent years, there is no assurance that this trend will continue. In addition, Hallwood Energy will require significant additional capital investment over the next few years to acquire additional properties and to adequately explore and develop existing and any new properties.

Textile Products. The Company derives substantially all of its operating revenues from the textile activities of its Brookwood Companies Incorporated (Brookwood) subsidiary; consequently, the Company's success is highly dependent upon Brookwood's success. 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 global trade regulation.

While Brookwood has enjoyed substantial growth in its military business, 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 will 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. Military sales of \$12,036,000 for the 2007 first quarter were 23.5% lower than the comparable period amount of \$15,728,000 in 2006.

The military has recently limited orders for existing products and adopted 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 a continuing challenge to adjust to changing specifications and production requirements. Brookwood is currently conducting research and development on various processes and products intended to comply with the revised specifications and participating in the bidding process for new military products. The U.S. government has recently released orders for goods that include Brookwood's products. However, to the extent Brookwood's products are not included in future purchases by the U.S. government for any reason, Brookwood's sales could be adversely affected. 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 sales trends.

Unstable global nylon and chemical pricing, coupled with domestic energy costs, are causing overall cost increases, which, together with product mix, have negatively impacted Brookwood's margins, a trend that appears likely to continue.

Brookwood continues to identify new market niches intended to replace sales lost to importers. In addition to its existing products and proprietary technologies, Brookwood has been developing advanced breathable, waterproof laminate and other materials, which have been well received by its customers. 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 maintain its level of military business and 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 developed 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 U.S. dollar in relation to other currencies and world economic developments. However, under NAFTA there are no textile and apparel quotas between the U.S. 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 U.S. has also approved the Central American-Dominican Republic Free Trade Agreement (CAFTA) with five Central American countries (Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua). Under CAFTA, textiles and apparel originating from CAFTA countries will be duty and quota-free, provided that yarn formed in the U.S. or

other CAFTA-DR countries is used to produce the fabric. In addition, the United States recently implemented bilateral free trade agreements with Bahrain, Chile, Israel, Jordan, Morocco and Singapore. Although these actions have the effect of 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.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

The textile products business is not interdependent with the Company's other business operations. The Company does not guarantee the Brookwood bank facility and is not obligated to contribute additional capital.

Energy. Hallwood Energy is an upstream energy partnership engaging in the acquisition, development, exploration, production, and sale of hydrocarbons, with a primary focus on natural gas assets. Hallwood Energy's results of operations are and will be largely dependent on a variety of variable factors, including, but not limited to fluctuations in natural gas prices; success of its exploratory drilling activities; the ability to transport and sell its natural gas; regional and national regulatory matters; and the ability to secure, and price of, goods and services necessary to develop its oil and gas leases. As of March 31, 2007, the Company owned approximately 25% (20% after consideration of profits interests) of Hallwood Energy.

Refer also to the section "Investments in Energy Affiliates" for a further description of the Company's energy activities.

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.

Results of Operations

The net loss for the 2007 first quarter was \$7,324,000, compared to net income of \$464,000 in 2006. Revenue for the 2007 first quarter was \$28,308,000, compared to \$30,775,000 in 2006.

Revenues

Textile products sales of \$28,308,000 decreased by \$2,467,000, or 8.0%, in the 2007 first quarter, compared to \$30,775,000, in 2006. The decrease was principally due to a decline of sales of specialty fabric to U.S. military contractors as a result of decreased orders from the military to Brookwood's customers, because of a limitation by the military for orders of existing products and the adoption of revised specifications for new products to replace the products for which Brookwood's customers have been suppliers. The decline in military sales was partially offset by Brookwood's development and marketing of new products and continued upgrade of its production equipment.

Sales to one customer, Tennier Industries, Inc. ("Tennier") accounted for more than 10% of Brookwood's net sales during both the 2007 and 2006 periods. Its relationship with Tennier is ongoing. Sales to Tennier, which are included in military sales, were \$6,895,000 in the 2007 first quarter, compared to \$9,544,000 in 2006, which represented 24.4% and 31.0% of its net sales, respectively. Sales to another customer, ORC Industries, Inc. ("ORC") accounted for more than 10% of Brookwood's sales in 2006. Its relationship with ORC is ongoing. Sales to ORC, which are also included in military sales, were \$2,206,000 in the 2007 first quarter, compared to \$3,830,000 in 2006, which represented 7.8% and 12.4% of its net sales, respectively.

Through 2005, military sales, including the sales to Tennier and ORC, generally comprised an increased portion of Brookwood's total sales and a greater share of gross profit. However, Brookwood has experienced reduced military sales since 2005. Military sales accounted for \$12,036,000 and \$15,728,000 in the 2007 and 2006 first quarters, respectively, which represented 42.5% and 51.1% of its net sales, respectively.

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

Textile products cost of sales of \$24,289,000 for the 2007 first quarter decreased by \$530,000, or 2.1%, compared to \$24,819,000 in 2006. The 2007 decrease principally resulted from reduced sales, changes in product mix and decreased energy costs of \$137,000. Cost of sales includes all costs associated with the manufacturing process, including but not limited to, materials, labor, utilities, depreciation on manufacturing equipment and all costs associated with the purchase, receipt and transportation of goods and materials to Brookwood's facilities, including inbound freight, purchasing and receiving costs, inspection costs, internal transfer costs and other costs of the distribution network. Brookwood believes that the reporting and composition of cost of sales and gross margin is comparable with similar companies in the textile converting and finishing industry.

The reduced gross profit margin for the 2007 first quarter (14.2% versus 19.4%) principally resulted from changes in customer volume and product mix.

Administrative and selling expenses were comprised of the following (in thousands):

	Three Months Ended March 31,	
	2007	2006
Textile products	\$ 3,521	\$ 3,481
Corporate	1,083	1,169
Total	\$ 4,604	\$ 4,650

Textile products administrative and selling expenses of \$3,521,000 for the 2007 first quarter increased by \$40,000, or 1.1%, from the 2006 amount of \$3,481,000. The increase was primarily attributable to higher professional fees in 2007. The textile products administrative and selling expenses included items such as payroll, professional fees, sales commissions, marketing, rent, insurance, travel and royalties. Brookwood conducts research and development activities related to the exploration, development and production of innovative products and technologies. Research and development costs were approximately \$174,000 and \$123,000 in the 2007 and 2006 quarters, respectively.

Corporate administrative expenses were \$1,083,000 for the 2007 first quarter, compared to \$1,169,000 for 2006. The decrease of \$86,000, or 7.4%, was principally attributable to reduced professional fees of \$141,000 and lower reimbursement of office expenses to HIL of \$65,000, partially offset by an increase in Sarbanes Oxley costs of \$65,000.

Other Income (Loss)

Equity loss from the Company's investments in Hallwood Energy, related to the Company's pro rata share of loss in Hallwood Energy, was \$10,503,000 in the 2007 first quarter, compared to \$350,000 in 2006. In the 2007 first quarter, Hallwood Energy recorded an impairment of \$31,680,000 associated with its oil and gas properties and accrued \$7,100,000 as a portion of a make-whole fee in connection with a May 2007 prepayment of a loan. The make-whole fee was included in interest expense. The Company earned interest income of \$12,000 in the 2007 first quarter from a loan it made to Hallwood Energy in March 2007. The 2006 results for Hallwood Energy include production from two wells in the Fort Worth Basin.

Interest expense of \$226,000 in the 2007 first quarter and \$117,000 for the 2006 quarter, principally relates to Brookwood's Key Bank revolving credit facility. The increase in interest expense was principally due to an increase in the average outstanding loan amount and higher interest rates.

Interest and other income was \$181,000 in the 2007 first quarter, compared to \$108,000 in 2006. The 2007 increase was principally due to the gain from the sale of a marketable security sold in March 2007, partially offset by reduced

interest income earned on lower balances of cash and cash equivalents.

Page 20

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

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

	Three Months Ended March 31,	
	2007	2006
Federal		
Current	\$	\$
Deferred	(3,794)	250
Sub-total	(3,794)	250
State		
Current	40	233
Deferred	(43)	
Sub-total	(3)	233
Total	\$ (3,797)	\$ 483

At March 31, 2007, the deferred tax asset was attributable to projected taxable losses that can be carried back for a refund, temporary differences, that upon reversal, could be utilized to offset income from operations and alternative minimum tax credits. The effective federal tax rate in both periods was 34%, while state taxes are determined based upon taxable income apportioned to those states in which the Company does business at their respective tax rates.

Investments in and Loans to Hallwood Energy, L.P.

At March 31, 2007, the Company owned approximately 25% (20% after consideration of profits interests) of Hallwood Energy. The Company accounts for this investment using the equity method of accounting and records its pro rata share of Hallwood Energy's net income (loss) and partner capital transactions.

A description of Hallwood Energy's activities during 2007 are provided below.

Loan Financing. In February 2006, Hallwood Energy entered into a \$65,000,000 loan facility, and had drawn \$40,000,000 as of December 31, 2006. Subsequent to December 31, 2006, Hallwood Energy was not in compliance with the proved collateral coverage ratio.

In March and April 2007, the Company advanced a total of \$5,000,000 and \$4,000,000, respectively, to Hallwood Energy, of which \$7,000,000 was in the form of demand notes bearing interest at 6% above prime rate, and \$2,000,000 was an advance that was repaid four days later with interest. In April 2007, Hallwood Energy made a request for additional capital contributions in the amount of \$25,000,000 (the April Call). The Company and Hallwood Energy had agreed that the \$7,000,000 amount previously advanced would be applied as the Company's portion of this capital call. On May 10, 2007, Hallwood Energy repaid \$257,000 to the Company, which represented the excess of the \$7,000,000 advanced over the Company's share of the capital contribution and related oversubscription.

In April 2007, Hallwood Energy entered into a \$100,000,000 senior secured credit facility (the Credit Facility) with an affiliate of one of the investors and drew \$65,000,000 from the Credit Facility. The proceeds were used to repay \$40,000,000 in an existing note payable, pay approximately \$9,800,000 for a make-whole fee and incremental interest of approximately \$500,000 to the original lender related to the \$40,000,000 note payable, and transaction fees

of approximately \$200,000. Borrowings under the Credit Facility are secured by Hallwood Energy's oil and gas leases, mature on February 1, 2010, and bear interest at a rate of the defined LIBOR rate plus 10.75% per annum. An additional 2% of interest is added upon continuance of any defaulting event. The new lender may demand that Hallwood Energy prepay the outstanding loans in the event of a defined change of control, qualified sale or event of default, including a material adverse event. In conjunction with executing the Credit Facility, the new lender resigned its position on the board of directors and assigned its general partner interest to the remaining members.

Provided that Hallwood Energy raises \$25,000,000 through an equity call or through debt subordinate to the Credit Facility (discussed below), the new lender will match subsequent amounts raised on a dollar for dollar basis up to the remaining

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

\$35,000,000 under the Credit Facility through the availability termination date of July 31, 2008. Hallwood Energy successfully completed the April Call in May 2007, of which the Company contributed \$6,743,000.

The Credit Facility contains various financial covenants, including maximum general and administrative expenditures and current and proved collateral coverage ratios. The proved collateral coverage ratio is effective June 30, 2008. Non-financial covenants restrict the ability of Hallwood Energy to dispose of assets, incur additional indebtedness, prepay other indebtedness or amend certain debt instruments, pay dividends, create liens on assets, enter into sale and leaseback transactions, make investments, loans or advances, make acquisitions, engage in mergers or consolidations or engage in certain transactions with affiliates, and otherwise restrict certain activities by Hallwood Energy.

The Credit Facility contains a make-whole provision whereby Hallwood Energy is required to pay the lender the amount by which the present value of interest and principal from the date of prepayment through January 31, 2009, exceeds the principal amount on the prepayment date. The lender received warrants exercisable for 2.5% of the partnership interests at an exercise price of 2.5% of 125% of the amount of the total capital contributed to Hallwood Energy at December 31, 2006.

Equity Investments. In November 2006, Hallwood Energy requested an additional capital contribution in the amount of \$25,000,000 from its partners. The Company invested an additional \$6,281,000 to maintain its proportionate interest in Hallwood Energy. The Company utilized a \$452,000 capital contribution receivable to reduce its cash contribution to \$5,829,000. In addition, certain other investors in Hallwood Energy did not elect to fund their proportionate interest of the additional capital contribution; therefore, in December 2006, the Company invested an additional \$425,000 and \$2,000 in January 2007 in excess of its proportionate interest. These contributions were made.

Hallwood Energy issued a \$25,000,000 equity call, the April Call, to its partners on April 14, 2007. Previously, Hallwood Energy received cash advances of \$7,000,000 each from the Company and an affiliate of the new lender. These advances were applied to the April Call. In May, Hallwood Energy repaid \$257,000 to the Company, which represented the excess of the \$7,000,000 advanced over the Company's share of the capital contribution and related oversubscription.

Hallwood Energy issued a \$20,000,000 equity call to its partners on May 21, 2007 (the May Call), which is due on July 1, 2007. The Company's proportionate share of the equity call is \$5,091,000. The Company anticipates that it will contribute \$2,500,000 towards the May Call, but does not have funds available to contribute substantial additional capital in connection with that or future calls.

For the funds received as a result of the April Call and the May Call, Hallwood Energy issued or will issue preferred partnership interests that will have a preferential right to any distributions made by Hallwood Energy from operations or upon liquidation. The preferential right will be equal to the amount of the capital contributed with respect to the preferred interest plus 16% per annum, compounded monthly. The preferred interests will receive this priority return before any amounts are paid to the common interests issued for all previous investments in Hallwood Energy. The capital contributed plus the accumulated 16% return attributable to any preferred interest is also convertible to common partnership interests at any time at a price equal to the price of the common partnership interests at December 31, 2006. Distributions on the preferred partnership interests will initially be accrued and become payable when, as and if declared by the general partner of Hallwood Energy. Hallwood Energy does not anticipate paying any distributions in the foreseeable future.

In April 2007, Hallwood Investments Limited (HIL), a corporation associated with Mr. Anthony J. Gumbiner the Company's chairman and principal stockholder, and the new lender have each committed to fund one-half of the April Call and potential additional equity or subordinated debt funding calls totaling \$55,000,000 by Hallwood Energy, to the extent other investors, including the Company, do not respond to a call. Pursuant to this commitment, HIL intends to fund that portion of the May Call that the Company does not fund. The Company and Mr. Gumbiner have agreed to discuss in the future the terms on which HIL will make this funding as between the Company and HIL.

Litigation. In early 2006, Hallwood Energy entered into two two-year contracts with Eagle Drilling, LLC (subsequently Eagle Drilling Operations, LLC), under which the contractor was to provide drilling rigs and crews to drill wells in Arkansas at a daily rate of \$18,500, plus certain expenses for each rig. In August 2006, one of the rigs provided by the contractor collapsed. Hallwood Energy requested the contractor to provide assurances that the other rig, and any rig provided to replace the collapsed rig, were safe and met the requirements of the contracts. When the contractor refused to provide these assurances, Hallwood Energy notified the contractor that the contracts were terminated and on September 6, 2006, filed *Hallwood Petroleum, LLC and Hallwood Energy, L.P. v. Eagle Drilling, LLC and Eagle Domestic Drilling Operations, LLC*, in the 348th District Court of Tarrant County, Texas to recover approximately \$1,688,000 previously deposited with the contractor under the contracts. Eagle Domestic Drilling Operations, LLC has asserted damages in excess of \$22,000,000 against Hallwood Energy, principally for breach of contract. Eagle Domestic Drilling Operations, LLC and its parent have since filed for Chapter 11 bankruptcy protection. Hallwood Energy is currently unable to determine the impact of this matter on its results of operations and financial position.

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

The following table reflects the status of Hallwood Energy's oil and gas investments as of May 1, 2007:

Description	Central Eastern Arkansas	South Louisiana	West Texas (a)	Total
Principal focus	Fayetteville Shale	Salt Dome	Barnett and Woodford Shale	
Initial funding	3 rd Quarter 2005	1 st Quarter 2004	3 rd Quarter 2004	
Company investment				\$57,132,000(b)
Company ownership percentage (c)				25%/20%
Net acres held (d)	460,000	(e)	17,300	
Operator	Hallwood Energy	Hallwood Energy	Chesapeake	
Well type: (f)				
Horizontal / directional	1	3	1	5
Vertical	12		2	14
Well status:				
Producing			1	1
Drilling	2	1	1	4
Successful / waiting pipeline	3			3
Evaluating/completing	4		2	6
Unsuccessful	4	2		6
Net production (Mcf/day)			240	240

a) Hallwood Energy owns a 40% working interest in these properties.

b) Represents \$40,960,000 in 2005, \$9,427,000 in 2006, \$2,000 in January 2007 and \$6,743,000 in April 2007.

c) Before and after consideration of profit interests held by management of

Hallwood
Energy.

- d) 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.
- e) Hallwood Energy holds options to acquire leases on approximately 17,000 acres. Based on the results of 3-D seismic data that have been analyzed, approximately 4,000-8,000 acres are expected to be retained for future development.
- f) All wells are natural gas wells. Represents the gross number of wells in which Hallwood Energy holds a working interest.

A description of activities in each area is provided below. Forward looking information is from current estimates by the management of Hallwood Energy, based on existing and anticipated conditions.

Central Eastern Arkansas

The primary objective formation is the Fayetteville Shale, which appears to range in depth from approximately 2,700 to 9,400 feet and to have a thickness of 300 to 700 feet.

Hallwood Energy commenced drilling activities in the 2006 first quarter and is currently drilling with two rigs under a long term contract, which also provides for four additional rigs. However, Hallwood Energy is currently in negotiations with the rig contractor to revise the contract to provide for three rigs with capabilities more suited to Hallwood Energy's properties. Hallwood Energy's 2007 budget forecasts 25 gross wells to be drilled in this area utilizing the three rigs. Hallwood Gathering, L.P. is currently constructing a 15 mile eight-inch gathering system in White County with an initial capacity of 6 million cubic feet of gas per day (Mcf/d), with expansion potential to 60 Mcf/d. Natural gas sales are expected to begin by July 2007.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

South Louisiana

Hallwood Energy holds options to acquire leases over approximately 17,000 acres to exploit a salt dome oil and gas opportunity in St. James, Ascension and Assumption parishes. Based on the results of the 3-D seismic data that has been analyzed, approximately 4,000 to 8,000 acres are expected to be retained for future development. Hallwood Energy has secured two rigs, the first rig started in October 2006 and has recently fulfilled its two well commitment. The second rig began drilling in December 2006 and is under contract for two years. The expectations for 2007 are that 6 wells will be drilled. Additional drilling equipment and funding will be assessed and determined based on the results of the initial wells.

West Texas

Hallwood Energy sold a 60% interest and transferred operations in these properties to Chesapeake in July 2006. Chesapeake has drilled to total depth on three wells. One of these wells is currently producing and selling gas, one well is currently being completed, and the third well is waiting on completion. Under the sales agreement with Chesapeake, two rigs were to complete drilling of the wells on which they were then being used and after being deployed elsewhere, both rigs would resume drilling on these properties in the second quarter of 2007. The 2007 budget calls for these rigs to drill five gross wells in West Texas during the year.

Fort Worth Basin, North Texas

These properties were sold to Chesapeake in July 2006. Hallwood Energy no longer has any involvement in activities related to these properties. Hallwood Energy's operating revenues in the year ended December 31, 2006 were from the two producing wells on these properties.

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, 2006.

Related Party Transactions

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. The annual amount is payable in monthly installments. The contract automatically renews for one-year periods if not terminated by the parties beforehand. 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 and for travel and related expenses to and from the Company's United States office. In addition, the Company also reimbursed Mr. Gumbiner for services, meals and other personal expenses related to the office separately maintained by Mr. Gumbiner. At Mr. Gumbiner's recommendation, the Company's board of directors determined in 2006 that the reimbursement for personal expenses related to his office would not continue after November 2006.

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

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

	Three Months Ended March 31,	
	2007	2006
Consulting fees	\$ 249	\$ 249
Office space and administrative services	40	105
Travel expenses	8	9
Total	\$ 297	\$ 363

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, stock options, profit interests 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.

HIL shares common offices, facilities and certain staff in its Dallas office with the Company. The Company pays certain common general and administrative expenses and charges HIL an overhead reimbursement fee for its allocable share of the expenses. For the three months ended March 31, 2007 and 2006, HIL reimbursed the Company \$38,000 and \$38,000, respectively, for such expenses.

In April 2007, HIL committed to fund one-half of potential additional equity or subordinated debt funding calls of \$55,000,000 (or \$27,500,000) by Hallwood Energy, to the extent other investors, including the Company, do not respond to a call.

Hallwood Energy. Hallwood Energy shares common offices, facilities and certain staff in its Dallas office with the Company. Hallwood Energy reimburses the Company for its allocable share of the expenses. For the three months ended March 31, 2007 and 2006, Hallwood Energy reimbursed the Company \$61,000 and \$70,000, respectively for such expenses.

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 March 31, 2007 (in thousands):

	Payments Due During the Year Ending December 31,						Total
	2007*	2008	2009	2010	2011	Thereafter	
Contractual Obligations							
Long term debt	\$ 184	\$ 158	\$ 27	\$ 13,686	\$	\$	\$ 14,055
Redeemable preferred stock				1,000			1,000
Operating leases	779	1,012	659	626	349	1,697	5,122
Total	\$ 963	\$ 1,170	\$ 686	\$ 15,312	\$ 349	\$ 1,697	\$ 20,177

* For the nine
months ended
December 31,
2007.

Estimated interest payments, based on the current principal balances and weighted averages interest rates, assuming the contractual repayment of the term loan debt and a renewal of the revolving credit facilities at their loan balances as of March 31, 2007, are \$774,000 for the nine months ending December 31, 2007 and \$1,020,000, \$1,014,000, \$1,013,000, and \$1,013,000, for the years ending December 31, 2008 through December 31, 2011, respectively.

Page 25

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

Employment Contracts. The Company and its Brookwood subsidiary have compensation agreements with various personnel and consultants. Generally, the agreements extend for one-year terms and are renewable annually.

2005 Long-Term Incentive Plan for Brookwood. In December 2005, the Company adopted The Hallwood Group Incorporated 2005 Long-Term Incentive Plan for Brookwood Companies Incorporated (2005 Long-Term Incentive Plan for Brookwood) to attract, retain and motivate key personnel of Brookwood. The terms of the incentive plan provide for a total award amount to participants equal to 15% of the fair market value of consideration received by the Company in a change of control transaction, as defined, in excess of the sum of the liquidation preference plus accrued unpaid dividends on the Brookwood preferred stock (approximately \$22,686,000 at March 31, 2007). Provided certain circumstances are met, the minimum total award amount shall be \$2,000,000. In addition, if certain members of Brookwood senior management do not have at least a two percent equity or debt interest in the entity with which the change of control transaction is completed, then the Company will be obligated to pay an additional \$2,600,000.

Hallwood Energy. The Company's Hallwood Energy affiliate has various contractual obligations and commercial commitments. At March 31, 2007, such obligations and commitments included \$40,000,000 for long-term debt, \$11,124,000 for interest, \$94,966,000 for long-term rig commitments and \$51,000 for operating leases.

Financial Covenants

Brookwood. The principal ratios, required to be maintained under Brookwood's Key Working Capital Revolving Credit Facility for the last four quarters are provided below:

Description	Requirement	Quarters Ended			
		March 31, 2007	December 31, 2006	September 30, 2006	June 30, 2006
Total debt to tangible net worth	must be less than 1.50	1.08	0.93	0.77	0.69
Net income	must exceed \$1	Yes	Yes	Yes	Yes

Brookwood was in compliance with its loan covenants under the Key Working Capital Revolving Credit Facility for the first quarter in 2007 and for all quarters in 2006.

Hallwood Energy. The principal ratios and covenants required to be maintained by Hallwood Energy under its Credit Facility are provided below:

General and administrative costs, excluding certain legal fees, can not exceed \$1,700,000 for any quarter, beginning June 30, 2007

Current ratio must exceed 1.00 to 1.00 each quarter, beginning June 30, 2007

Proved collateral coverage ratio (including cash) must exceed 2.00 to 1.00 each quarter, beginning June 30, 2008

Non-financial covenants restrict the ability of Hallwood Energy to dispose of assets, incur additional indebtedness, prepay other indebtedness or amend certain debt instruments, pay dividends, create liens on assets, enter into sale and leaseback transactions, make investments, loans or advances, make acquisitions, engage in mergers or consolidations or engage in certain transactions with affiliates, and otherwise restrict certain activities by Hallwood Energy. The new lender may demand that Hallwood Energy prepay the outstanding loans in the event of a defined change of control, qualified sale or event of default, including a material adverse event.

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

General. The Company principally operates in the textile products and energy business segments. The Company's cash position decreased by \$4,170,000 during the 2007 first quarter to \$5,884,000 as of March 31, 2007. The principal source of cash in 2007 was \$3,163,000 from net bank borrowings. The primary uses of cash were \$1,957,000 for operating activities, \$5,002,000 for an additional investment in Hallwood Energy and \$375,000 for property, plant and equipment.

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 2010. At March 31, 2007, Brookwood had approximately \$8,314,000 of unused borrowing capacity on its revolving line of credit facility and \$2,631,000 on its equipment credit facility.

Brookwood paid cash dividends to the Company of \$3,000,000 in the four month period ended April 30, 2007 and \$6,000,000 for all of 2006. In addition, Brookwood made payments to the Company of \$621,000 in the four month period ended April 30, 2007 and \$738,000 for all of 2006 under its tax sharing agreement. Future cash dividends and tax sharing payments are contingent upon Brookwood's continued profitability and compliance with its loan covenants. Brookwood was in compliance with its loan covenants as of March 31, 2007 and for all interim periods in 2006. There were no significant additional capital requirements as of March 31, 2007.

Energy. In February 2006, Hallwood Energy entered into a \$65,000,000 loan facility, and had drawn \$40,000,000 as of December 31, 2006. Subsequent to December 31, 2006, Hallwood Energy was not in compliance with the proved collateral coverage ratio. In April 2007, Hallwood Energy repaid the \$40,000,000 outstanding principal balance of the former loan from proceeds of a new \$100,000,000 Credit Facility, under which it has drawn \$65,000,000.

Prior to the April 2007 funding of the Credit Facility, the Company had advanced \$7,000,000 to Hallwood Energy pursuant to demand notes bearing interest at 6% above prime rate. In April 2007, Hallwood Energy made a request for additional capital contributions in the amount of \$25,000,000. The Company and Hallwood Energy had agreed that the \$7,000,000 amount previously advanced would be applied as the Company's portion of this capital call. On May 10, 2007, Hallwood Energy repaid \$257,000 to the Company, which represented the excess of \$7,000,000 advanced over the Company's share of the capital contribution and related oversubscription.

Hallwood Energy issued a \$20,000,000 equity call, the May Call, to its partners on May 21, 2007, which is due on July 1, 2007. The Company's proportionate share of the May Call is \$5,091,000. In addition, as contemplated by the Credit Facility, Hallwood Energy also currently anticipates making requests for additional capital contributions in the amount of \$15,000,000 from its partners later in 2007. The Company currently intends to fund approximately \$2,500,000 of the May Call but does not have funds available to contribute substantial capital in connection with that or future calls. To the extent the Company does not make future capital contributions in proportion to its interest in Hallwood Energy, its percentage ownership interest will be reduced.

In April 2007, HIL and the new lender have each committed to fund one-half of the April Call and potential additional equity or subordinated debt funding calls totaling \$55,000,000 by Hallwood Energy, to the extent other investors, including the Company, do not respond to a call. Pursuant to this commitment, HIL intends to fund that portion of the May Call that the Company does not fund. The Company and Mr. Gumbiner have agreed to discuss in the future the terms on which HIL will make this funding as between the Company and HIL.

However, the timing and amount of any additional capital contributions to Hallwood Energy are uncertain. Hallwood Energy may determine that greater or lesser equity funding is required during 2007 and may determine to seek funding from sources other than existing investors. The actual level of Hallwood Energy's capital requirements during 2007 and thereafter 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, access to gathering and transportation infrastructure, and the availability of alternative sources of

capital, such as loans from third parties or equity contributions from new investors.

Future Liquidity. 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. Considering its current cash position and its anticipated cash flow from continuing operations, the Company believes it has sufficient funds to meet its liquidity needs,

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

although the Company is unlikely to be able to fund substantial additional capital contributions to Hallwood Energy after April 2007.

Page 28

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

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, 2006 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.

Page 29

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes to the Company's market risks during the quarter ended March 31, 2007.

The Company is exposed to market risk due to fluctuations in interest rates. The Company historically has utilized both fixed rate and variable rate debt to finance its operations. As of March 31, 2007, the Company's total outstanding loans payable of \$14,055,000 were comprised of \$108,000 of fixed rate debt and \$13,947,000 of variable rate debt. There is inherent rollover risk for borrowings as they mature and are renewed at current market rates. The extent of this risk is not quantifiable or predictable because of the variability of future interest rates and the Company's future financing requirements. A hypothetical increase in interest rates of one percentage point would cause an annual loss in income and cash flows of approximately \$140,000, assuming that outstanding debt remained at current levels.

The Company does not have any derivative financial instruments as of March 31, 2007.

Hallwood Energy has a make-whole provision contained within its former and current loan facilities. The make-whole fee is recorded at its estimated fair value on Hallwood Energy's balance sheet and changes in its fair value are recorded in interest expense in Hallwood Energy's statement of operations.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

Item 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures. It is the conclusion of the Company's principal executive officer and principal financial officer that the Company's disclosure controls and procedures (as defined in Exchange Act rules 13a-15(e) and 15d-15(e)), based on their evaluation of these controls and procedures as of the end of the period covered by this Form 10-Q, are effective at the reasonable assurance level in ensuring that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Management necessarily applied its judgment in assessing the costs and benefits of such controls and procedures, which, by their nature, can provide only reasonable assurance regarding management's control objectives. The design of any system of controls and procedures is based in part upon certain assumptions about the likelihood of future events. There can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

In August 2003, the Company's independent registered public accounting firm provided written communications to management and the audit committee on the need to improve the financial closing process at the Brookwood subsidiary. In April 2004, the Company received a further written communication from the independent registered public accounting firm to management and the audit committee on the continued need to improve the Brookwood financial closing process. In March 2005, March 2006 and May 2007, the Company received communications from its independent registered public accounting firm that further improvements in the financial systems and processes at its Brookwood subsidiary are still required. With the addition of new staff, Brookwood's management believes it has made substantial progress both in the timeliness and accuracy of the closing process. In addition, Brookwood is currently implementing a new order processing and inventory control system and updating its general ledger system, which will integrate various accounting processes. The new systems will further aid in accelerating and automating the financial closing process.

Internal Controls. Other than the improvements noted above, there were no changes in the Company's internal controls over financial reporting that occurred during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, these controls.

Table of Contents

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

<u>Item</u>	
1	Legal Proceedings Reference is made to Note 9 to the Company's condensed consolidated financial statements included within this Form 10-Q.
1A	Risk Factors N/A
2	Unregistered Sales of Equity Securities and Use of Proceeds None
3	Defaults upon Senior Securities None
4	Submission of Matters to a Vote of Security Holders None
5	Other Information None
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: June 4, 2007

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

Page 33

Table of Contents

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

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Page 34