HALLWOOD GROUP INC
Form 10-Q
November 14, 2006

Table of Contents

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

MARK ONE

þ **QUARTERLY 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 Period Ended September 30, 2006
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

1,514,595 shares of Common Stock, $0.10 par value per share, were outstanding at October 31, 2006.

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
TABLE OF CONTENTS

Table of Contents

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

	September 30, 2006	December 31, 2005
ASSETS		
Current Assets		
Cash and cash equivalents	$ 15,459	$ 16,648
Accounts receivable		
Trade and other	16,689	18,987
Related parties	589	616
Inventories	18,749	16,879
Prepaid income taxes	1,689	1,322
Deferred income tax	1,097	1,029
Prepaids, deposits and other assets	562	831
	54,834	56,312
Noncurrent Assets		
Investment in energy affiliate	41,877	40,854
Property, plant and equipment, net	13,058	11,358
Other assets	263	277
	55,198	52,489
Total Assets	$ 110,032	$ 108,801
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Accounts payable	$ 8,935	$ 7,274
Accrued expenses and other current liabilities	4,547	4,848
Current portion of loans payable	311	352
Income taxes payable	11	9
	13,804	12,483
Noncurrent Liabilities		
Long term portion of loans payable	7,239	6,460
Redeemable preferred stock	1,000	1,000
Deferred income tax	236	415
	8,475	7,875

Total Liabilities		22,279		20,358
Stockholders Equity				
Common stock, issued 2,396,105 and 2,396,103 shares, respectively; outstanding 1,514,595 and 1,511,218 shares, respectively		240		240
Additional paid-in capital		56,395		56,258
Retained earnings		44,249		45,126
Treasury stock, 881,510 and 884,885 shares, respectively; at cost		(13,131)		(13,181)
Total Stockholders Equity		87,753		88,443
Total Liabilities and Stockholders Equity	$	110,032	$	108,801

See accompanying notes to condensed consolidated financial statements.

Table of Contents

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

	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Revenues		
Textile products sales	$ 84,528	$ 101,923
Administrative fees from energy affiliates		1,499
	84,528	103,422
Expenses		
Textile products cost of sales	69,753	80,262
Administrative and selling expenses	13,985	24,151
	83,738	104,413
Operating income (loss)	790	(991)
Other Income (Loss)		
Equity loss from investments in energy affiliates	(1,699)	(8,302)
Interest expense	(407)	(436)
Interest and other income	385	1,238
Gain from disposition of HE III		51,956
Adjustment to gain from disposition of HEC		(113)
	(1,721)	44,343
Income (loss) before income tax expense (benefit)	(931)	43,352
Income tax expense (benefit)	(48)	17,828
Net Income (Loss)	$ (883)	$ 25,524
Net Income (Loss) Per Common Share		
Basic	$ (0.58)	$ 17.93
Assuming dilution	$ (0.58)	$ 16.93
Weighted Average Shares Outstanding		
Basic	1,513	1,423

Assuming dilution	1,513	1,508

See accompanying notes to condensed consolidated financial statements.

Table of Contents

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

	Three Months Ended September 30,	
	2006	**2005**
Revenues		
Textile products sales	$ 25,055	$ 30,239
Expenses		
Textile products cost of sales	20,935	23,760
Administrative and selling expenses	4,704	5,311
	25,639	29,071
Operating income (loss)	(584)	1,168
Other Income (Loss)		
Equity loss from investments in energy affiliates	(665)	(8,497)
Interest expense	(156)	(134)
Interest and other income	151	391
Gain from disposition of HE III		51,956
	(670)	43,716
Income (loss) before income tax expense (benefit)	(1,254)	44,884
Income tax expense (benefit)	(406)	15,949
Net Income (Loss)	$ (848)	$ 28,935
Net Income (Loss) Per Common Share		
Basic	$ (0.56)	$ 19.15
Assuming dilution	$ (0.56)	$ 18.95
Weighted Average Shares Outstanding		
Basic	1,515	1,511
Assuming dilution	1,515	1,527

See accompanying notes to condensed consolidated financial statements.

Table of Contents

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

	Common Stock		Additional Paid-In	Retained	Treasury Stock		Total Stockholders
	Shares	**Par Value**	**Capital**	**Earnings**	**Shares**	**Cost**	**Equity**
Balance, January 1, 2006	2,396	$ 240	$ 56,258	$ 45,126	885	$ (13,181)	$ 88,443
Net loss				(883)			(883)
Reissuance of treasury shares from exercise of stock options and related income tax effect			137	6	(3)	50	193
Balance, September 30, 2006	2,396	$ 240	$ 56,395	$ 44,249	882	$ (13,131)	$ 87,753

See accompanying notes to condensed consolidated financial statements.

Page6

Table of Contents

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

	Nine Months Ended September 30,	
	2006	**2005**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	$ (883)	$ 25,524
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Equity loss from investments in energy affiliates	1,699	8,302
Depreciation and amortization	1,359	1,327
Deferred tax expense (benefit)	(247)	917
Excess tax benefits from share-based payment arrangements	(137)	
Gain from disposition of HE III		(51,956)
Proceeds from sale of marketable securities		6,051
Adjustment to gain from disposition of HEC		113
Loss from investments in marketable securities		49
Changes in assets and liabilities:		
Decrease in accounts receivable	2,325	4,024
(Increase) decrease in inventories	(1,870)	6,021
Increase (decrease) in accounts payable	1,615	(6,315)
Net change in other assets and liabilities	282	(453)
Increase (decrease) in income taxes payable/prepaid	(228)	6,755
(Decrease) in accrued expenses and other current liabilities	(301)	(1,013)
Discontinued operations:		
Net change in other assets and liabilities		146
Net cash provided by (used in) operating activities	3,614	(508)
CASH FLOWS FROM INVESTING ACTIVITIES		
Investments in property, plant and equipment, net	(3,013)	(1,586)
Investments in energy affiliates	(2,721)	(18,264)
Proceeds from disposition of investment in HE III		54,850
Proceeds from sale of investment in HEC		387
Discontinued operations:		
Proceeds from sale of investments in HRP, net		59
Net cash provided by (used in) investing activities	(5,734)	35,446
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from (repayment of) revolving credit facilities, net	1,000	(977)
Repayment of other bank borrowings and loans payable	(262)	(262)
Excess tax benefits from share-based payment arrangements	137	
Proceeds from exercise of stock options	56	2,207

Cash dividends on common stock		(66,113)
Net cash provided by (used in) financing activities	931	(65,145)
DECREASE IN CASH AND CASH EQUIVALENTS	(1,189)	(30,207)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	16,648	71,549
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 15,459	$ 41,342

See accompanying notes to condensed consolidated financial statements.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Nine Months Ended September 30, 2006 and 2005
(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, 2005.

Comprehensive Income. The Company had no items of other comprehensive income in any period presented. Accordingly, condensed consolidated statements of comprehensive income are not required and have not been provided.

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 January 1, 2006, the Company had investments in Hallwood Energy III, L.P. (HE III), 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 26% of the entities (between 17% and 21% on a fully diluted basis) and accounted for its investments using the equity method of accounting. HE III was sold in July 2005. 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 East 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, all energy activities are conducted by Hallwood Energy. At September 30, 2006, the Company owned approximately 25% (20% after consideration of profit interests) of Hallwood Energy.

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 Energy Corporation (Chesapeake). Chesapeake assumed operation of these properties. See Note 3.

Following the July 2006 sale to Chesapeake, Hallwood Energy s management has classified its energy investments into three identifiable areas: East Arkansas, South Louisiana and West Texas.

New Accounting Pronouncements. On January 1, 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payments* using a modified method of prospective application. See Note 5.

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 clarifies the accounting and reporting for income taxes recognized in accordance with SFAS No. 109, *Accounting for Income Taxes* . FIN 48 prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. The Company is currently evaluating the impact of FIN 48 and will adopt FIN 48 in the first quarter of 2007.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Nine Months Ended September 30, 2006 and 2005
(unaudited)

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* . This Statement defines fair value as used in numerous accounting pronouncements, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosure related to the use of fair value measures in financial statements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is currently evaluating the timing of adoption and the impact that adoption might have on its financial position or results of operations.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108 (SAB 108). Due to diversity in practice among registrants, SAB 108 expresses SEC staff views regarding the process by which misstatements in financial statements are evaluated for purposes of determining whether financial statement restatement is necessary. SAB 108 is effective for fiscal years ending after November 15, 2006, and early application is encouraged. The Company does not believe SAB 108 will have a material impact on its financial position or results of operations.

On May 18, 2006, the State of Texas passed a bill to replace the current franchise tax with a new margin tax to be effective January 1, 2008. The Company estimates the new margin tax will not have a significant impact on tax expense or deferred tax assets and liabilities.

Note 2 Inventories

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

	September 30, 2006	**December 31, 2005**
Raw materials	$ 6,691	$ 6,257
Work in progress	5,744	5,103
Finished goods	7,067	6,093
	19,502	17,453
Less: Obsolescence reserve	(753)	(574)
Total	$ 18,749	$ 16,879

Note 3 Investments in Energy Affiliates

Investments in energy affiliates as of the balance sheet dates were as follows (in thousands):

Hallwood Energy, L.P.

	Cost as of	Amount at which carried at		Income (loss) for the nine months ended	
	September 30,	**September 30,**	**December 31,**	**September 30,**	
Description of Investment	**2006**	**2006**	**2005**	**2006**	**2005**
Hallwood Energy, L.P.					
- Limited partner interest	$ 43,675	$ 41,872	$ 40,848	$ (1,698)	$ 326
- General partner interest	6	5	6	(1)	

Total	$ 43,681	$ 41,877	$ 40,854	$ (1,699)	$ 326

At September 30, 2006, 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.

Effective December 31, 2005, HE II and Hallwood Exploration were consolidated into HE 4, which was renamed Hallwood Energy. In January 2006, the Company invested an additional $2,721,000 in Hallwood Energy. The equity income for the nine months ended September 30, 2005 was an aggregate of the income previously reported by HE II, HE 4 and Hallwood Exploration.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Nine Months Ended September 30, 2006 and 2005
(unaudited)

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	
HE 4	$ 22,325
HE II	14,011
Hallwood Exploration	4,624
Accumulated equity loss	(106)
Total	$ 40,854

The HE II investment included a non-cash contribution of $889,000 in July 2005, which was the result of a deemed distribution of the Company s proportionate share of certain pipe inventory owned by HE III at the time of HE III s disposition, which was then contributed to HE II as an additional capital investment.

Following the completion of the energy consolidation on December 31, 2005, all energy activities are conducted by Hallwood Energy. Following 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: East Arkansas, South Louisiana and West Texas.

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 are provided below.

Operations. During the first quarter of 2006, Hallwood Energy entered into a participation agreement (the Participation Agreement) with Activa Resources, Ltd. Under the Participation Agreement, upon Activa s payment of approximately $4,960,000 to Hallwood Energy, which was received in April 2006, Hallwood Energy transferred to Activa an undivided 25% interest in oil and gas leases with respect to 44,219 net acres that Hallwood Energy currently holds in East Arkansas. During the term of the Participation Agreement, Hallwood Energy is designated as operator of the leases. As operator, Hallwood Energy was required to commence actual drilling operations before June 2006 for the first of two initial wells. Hallwood Energy has commenced this drilling. Activa agreed to participate to the extent of its participation interest in the two initial wells, and paid 50% of the first $750,000 incurred for costs associated with the drilling, completion and equipping operations in connection with each of the initial wells.

The Participation Agreement also establishes an area of mutual interest (the AMI) potentially covering an area of approximately 184,000 gross acres, which area includes the 44,219 acres. Pursuant to the AMI, Hallwood Energy will have the right to an undivided 75% participation interest, and Activa will have the right to an undivided 25% participation interest, in any additional leases acquired by either of the parties within the AMI. If either party acquires any additional leases covering lands within the AMI, it must offer the other party the right to acquire its participation interest in the leases acquired. The agreement related to the acquisition of additional leases expires in December 2007.

In April 2006, Hallwood Energy sold a 5% limited partner interest to an affiliate of its lender.

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. The sales price of $39,400,000, including reimbursement of certain development and drilling costs and subject to any post closing adjustments, exceeded the book value of the assets sold by $10,600,000. The excess amount was credited to the full cost pool. Completion of the transaction enables Hallwood Energy to increase its operational focus on its properties in East Arkansas and South Louisiana and reduce its capital requirements in West Texas while retaining a significant interest in the economic potential of the West Texas properties.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Nine Months Ended September 30, 2006 and 2005
(unaudited)

Financing. In February 2006, Hallwood Energy entered into a $65,000,000 loan facility and had drawn $40,000,000 as of September 30, 2006. At September 30, 2006, Hallwood Energy was in technical default under the loan facility because of, among other things, Hallwood Energy s general and administrative expenses exceeded the maximum amount permitted under the loan facility and Hallwood Energy had not yet completed the mortgage of leases covering at least 350,000 acres in East Arkansas. Hallwood Energy is in the process of completing the mortgages and negotiating with the lender a waiver of all defaults and an amendment of the loan facility. As a result of these efforts, and in connection with an additional $25,000,000 capital contribution expected to be made by its investors in the 2006 fourth quarter, Hallwood Energy expects the lender to waive the defaults, but no agreement has been signed to date and there can be no assurance that the waiver and amendment will be successfully completed. Hallwood Energy currently anticipates drawing the remaining $25,000,000 of the loan facility in 2007 after execution of the loan waiver and amendment agreements.

Litigation. In early 2006, Hallwood Energy entered into two two-year contracts under which a 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 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. Management does not currently believe that the resolution of this matter will have a material adverse effect on the Company.

The following table sets forth summarized statement of operations data for Hallwood Energy for the nine months ended September 30, 2006 (in thousands):

Revenues and Other Income	
Natural gas sales	$ 774
Interest and other income	1,311
Total revenues and other income	2,085
Operating and Other Expenses	
Operating expenses	8,288
Depreciation and depletion	486
Other expenses	2
Total operating and other expenses	8,776
Net Loss	$ (6,691)

Hallwood Energy III, L.P.

	Cost as of	Amount at which carried at	Income (loss) for the nine months ended September 30,

Description of Investment	September 30, 2006	September 30, 2006	December 31, 2005	2006	2005
Hallwood Energy III, L.P.					
- Limited partner interest					$ (8,628)

Prior to the sale of HE III in July 2005 (discussed below), the Company owned approximately 28% (24% after consideration of profit interests) of HE III. It accounted for this investment using the equity method of accounting and recorded its pro rata share of HE III s net income (loss) and partner capital transactions. In 2004, the Company invested $4,705,000 in HE III, which was formed primarily to acquire and develop oil and gas lease holdings in the Barnett Shale formation of Johnson and Hill Counties, Texas. In March 2005, the Company invested an additional $4,251,000 in HE III.

In March 2005, an agreement was entered into with a former officer of the energy affiliates, who was not otherwise affiliated with the Company, to purchase the officer s four percent profit interest in the energy affiliates for $4,000,000, of which

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Nine Months Ended September 30, 2006 and 2005
(unaudited)

$3,500,000 was ascribed to HE III and $250,000 each to HE II and Hallwood Exploration. The purchase was settled by the energy affiliates in July 2005. The energy affiliates recorded the purchase amount as compensation expense in the 2005 first quarter and the Company reflected its pro rata share, approximately $1,100,000, as a reduction of the equity income from the energy affiliates.

Sale of HE III. In July 2005, HE III completed a merger with Chesapeake. In exchange for its interest in HE III, the Company received a cash payment of $54,850,000 in July 2005 and received an additional $799,000 in November 2005 from the final working capital adjustment. In addition, the Company received a distribution for its proportionate share of certain pipe inventory owned by HE III, with a proportionate carrying value of approximately $889,000, which was contributed to HE II as an additional capital investment. The Company also recorded a receivable in the amount of $470,000 for the settlement of a working capital adjustment with HPL. The receivable is expected to be contributed to Hallwood Energy in the 2006 fourth quarter as an additional capital investment.

Certain of the Company s officers and directors were investors in HE III. In addition, as members of management of HE III, one director and officer and one officer of the Company held a profit interest in HE III.

Hallwood Energy Corporation

In December 2004, Hallwood Energy Corporation (HEC), a former affiliate, completed a merger with Chesapeake. In connection with the merger, the Company sold its 28% ownership interest (22% after consideration of stock options) of HEC and received a cash payment of $53,793,000. The Company also recorded a receivable in the amount of $500,000 for the settlement of HEC s working capital. The Company received $387,000 in April 2005 as its share of the working capital and reduced the gain from the disposition of HEC by $113,000 in the 2005 first quarter.

Hallwood Petroleum, LLC

The Company s former Hallwood Petroleum, LLC subsidiary (HPL) commenced operation in October 2004 as an administrative and management company to facilitate record keeping and processing for the energy affiliates and had no financial value. All revenues were credited to, and all costs were borne by, the other energy affiliates with no profit element. All assets nominally in the name of HPL were held solely for the benefit of the other energy affiliates. HPL was formed as a subsidiary of the Company as a convenience and it was not intended that it have any financial impact on the Company. In the 2005 third quarter, the Company determined that its ownership of this pass-through entity created unnecessary complexity. Therefore, HPL was transferred, for nominal consideration to officers of the energy affiliates that were not officers of the Company. The transfer was completed in May 2005. HPL was acquired by Hallwood Energy for nominal consideration in connection with the December 31, 2005 consolidation.

Other Entities

The Company invested nominal amounts in other affiliated entities which principally served as the general partners for the energy affiliates. These entities were included in the energy consolidation on December 31, 2005.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Nine Months Ended September 30, 2006 and 2005
(unaudited)

Note 4 C Loans Payable

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

	September 30, 2006	December 31, 2005
Bank debt		
Revolving credit facility, interest at Libor +1.25% - 1.75% or Prime, due January 2010	$ 7,000	$ 6,000
Equipment term loans, interest at various rates, due at various dates from March 2007 through February 2009	550	812
Total	7,550	6,812
Current portion	(311)	(352)
Noncurrent portion	$ 7,239	$ 6,460

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 covenants. The interest rate was 7.11% at September 30, 2006. The outstanding balance at September 30, 2006 was $7,000,000 and Brookwood had $15,000,000 of borrowing availability under this facility.

Equipment Term Loans. Brookwood also has a revolving equipment credit facility in an amount up to $3,000,000 with Key Bank. Interest rates for the equipment term loans varied between 5.60% and 8.65% at September 30, 2006. The outstanding balance at September 30, 2006 was $550,000 and Brookwood had $2,450,000 of borrowing availability under this facility.

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. Brookwood was in compliance with its loan covenants for the first three quarters of 2006 and for all quarters in 2005.

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, from Prime plus 0.25%, or Libor + 1.75% 3.00%, (variable depending on compliance ratios).

Note 5 C 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. In May and June 2005, directors and officers exercised 184,875 options to purchase shares of the Company s common stock. The Company issued common shares from its treasury stock.

In May 2006, the estate of a former officer of the Company exercised its remaining options to purchase 3,375 shares of the Company s common stock. The Company received proceeds of $56,000 from the exercise of these options and reissued the shares out of treasury stock. The $6,000 difference between the option proceeds and the average cost of reissued treasury shares of $50,000 was recorded as an increase in retained earnings.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Nine Months Ended September 30, 2006 and 2005
(unaudited)

At September 30, 2006, there were 15,750 fully vested outstanding options, of which 11,250 expire in 2007 and 4,500 expire in 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.

On January 1, 2006, the Company adopted SFAS No. 123(R), *Share-Based Payments* using a modified method of prospective application. Under SFAS No. 123(R), all forms of share-based payments to employees, including employee stock options, are treated the same as other forms of compensation by recognizing the related cost in the statement of operations. The expense of the award would generally be measured at fair value at the grant date. SFAS No. 123(R) eliminates the ability to account for share-based compensation transactions using APB Opinion No. 25. All options were fully vested as of December 31, 2005. The Company granted no options in the first nine months of 2006 or 2005. Because all of the Company s stock options are fully vested, there was no impact on income before taxes or net income from adopting SFAS No. 123(R).

Option activity for the nine months ended September 30, 2006 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, 2006	19,125	$ 15.10		
Granted				
Exercised	(3,375)	$ 16.58		
Forfeited				
Outstanding, September 30, 2006	15,750	$ 14.79	1.58	$ 1,248,000
Options exercisable at September 30, 2006	15,750		1.58	$ 1,248,000
Vested at September 30, 2006	15,750		1.58	$ 1,248,000

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 2006 third quarter and the exercise price, multiplied by the number of options).

Note 6 Income Taxes

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Federal				

Deferred	$ (227)	$ 678	$ (246)	$ 917
Current	(230)	14,894	(230)	15,551
Sub-total	(457)	15,572	(476)	16,468
State	51	377	428	1,360
Total	$ (406)	$ 15,949	$ (48)	$ 17,828

The net deferred tax asset was $861,000 and $614,000 at September 30, 2006 and December 31, 2005, respectively. The net deferred tax asset was attributable solely to temporary differences, that upon reversal, can be utilized to offset income from

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Nine Months Ended September 30, 2006 and 2005
(unaudited)

operations. The effective federal tax rate in both periods was 35%. State taxes are determined based upon taxable income apportioned to those states in which the Company does business at their respective tax rates, which vary from 0% to 17%.

Note 7 C 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	Nine Months Ended September 30, 2006	2005
Change in accrued capital expenditures accounts payable	$ 46	
Transfer of HPL net assets to officers of the energy affiliates:		
Restricted cash		$ 218
Prepaids, deposits and other assets		85
Property, plant and equipment, net		588
Other noncurrent assets		138
Accounts payable		(584)
Accrued expenses and other current liabilities		(445)
		$
Income tax effect from exercise of stock options:		
Income taxes payable		$ (1,651)
Additional paid-in capital		1,651
		$

Supplemental disclosures of cash payments:

Description	Nine Months Ended September 30, 2006	2005
Income taxes paid	$431	$10,153
Interest paid	404	364

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Nine Months Ended September 30, 2006 and 2005
(unaudited)

Note 8 C Computation of Income (Loss) Per Common Share

The following table reconciles weighted average shares outstanding from basic to assuming dilution methods (in thousands):

Description	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Weighted Average Shares Outstanding				
Basic	1,515	1,511	1,513	1,423
Potential shares from assumed exercise of stock options		19		108
Potential repurchase of shares from stock option proceeds		(3)		(23)
Assuming dilution	1,515	1,527	1,513	1,508
Net Income (Loss)				
Basic and assuming dilution	$ (848)	$ 28,935	$ (883)	$ 25,524

Due to the loss in the three and nine month 2006 periods, potential shares from assumed exercise of stock options in the amount of 9,000 shares for both periods in 2006 were antidilutive.

Note 9 C 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, 2005.

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. See Note 3 for a discussion 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 Brookwood s subsidiary, Kenyon Industries, Inc. (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 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.

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Nine Months Ended September 30, 2006 and 2005
(unaudited)

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 applied for approval with RIDEM and commenced remediation activities, which were completed in July 2006. In the 2006 first quarter, Brookwood accrued an additional $35,000 for remediation costs.

Note 10 C Segments and Related Information

The following represents the Company s reportable segment operations for the three months and nine months ended September 30, 2006 and 2005, respectively (in thousands):

	Textile Products	Energy	Other	Consolidated
Three months ended September 30, 2006				
Total revenue from external sources	$ 25,055			$ 25,055
Operating income (loss)	$ 563	$	$ (1,147)	$ (584)
Other income (loss), net	(156)	(665)	151	(670)
Income (loss) before income tax	$ 407	$ (665)	$ (996)	$ (1,254)
Three months ended September 30, 2005				
Total revenue from external sources	$ 30,239			$ 30,239
Operating income (loss)	$ 2,771	$	$ (1,603)	$ 1,168
Other income (loss), net	(134)	43,459	391	43,716
Income (loss) before income tax	$ 2,637	$ 43,459	$ (1,212)	$ 44,884
Nine months ended September 30, 2006				
Total revenue from external sources	$ 84,528			$ 84,528
Operating income (loss)	$ 4,440	$	$ (3,650)	$ 790
Other income (loss), net	(407)	(1,699)	385	(1,721)
Income (loss) before income tax	$ 4,033	$ (1,699)	$ (3,265)	$ (931)
Nine months ended September 30, 2005				
Total revenue from external sources	$ 101,923	$ 1,499		$ 103,422
Operating income (loss)	$ 9,464	$	$ (10,455)	$ (991)

Other income (loss), net	(436)	43,541	1,238	44,343
Income (loss) before income tax	$ 9,028	$ 43,541	$ (9,217)	$ 43,352

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, 2005 annual report. The total assets for the Company s operating segments have not materially changed since the December 31, 2005 annual report.

Page 17

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 textile products and energy. Although the Company s textile products 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 products 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 revenue from its military business during the past few years, there is no assurance this trend will continue. Brookwood s sales to the customers from whom it derives its military business have been 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 $11,532,000 and $40,449,000 for the 2006 third quarter and nine month periods, respectively, were 31.7% and 28.6% lower, respectively, than the comparable periods in 2005.

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. Brookwood is currently conducting research and development on various processes and products intended to comply with the revised specifications and anticipates that it will participate in the bidding process for the new military products. If Brookwood s products do not comply with the revised specifications or are not selected by the U.S. Government for any other reason, then Brookwood may 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.

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-DR) with six Central American countries (Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras and Nicaragua).

Under CAFTA-DR, textiles and apparel originating from CAFTA-DR 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, Australia, Israel, Jordan, Morocco and Singapore. Although these actions have the

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
Item 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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.

Energy. Following the sale of Hallwood Energy III, L.P. (HE III) in July 2005, the Company s remaining principal energy 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 26% of the entities (between 17% and 21% 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 transactions and comprehensive income (loss). These private companies were principally involved in acquiring oil and gas leases and drilling, gathering and sale of natural gas in the Barnett Shale formation of Parker, Hood and Tarrant Counties in North Texas, the Barnett Shale and the Woodford Shale formation in West Texas, the Fayetteville Shale formation in East 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. Effective December 31, 2005, the remaining private energy affiliates were consolidated into HE 4, which was renamed Hallwood Energy L.P. (Hallwood Energy). As of September 30, 2006, the Company owned approximately 25% (20% after consideration of profit interests) of Hallwood Energy.

In July 2006, Hallwood Energy completed the sale of a 60% undivided working interest in its oil and gas properties in West Texas and all of its interest in the Parker, Hood and Tarrant County properties in North Texas to Chesapeake Energy Corporation (Chesapeake), which became the operator of these properties.

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 2006 third quarter was $848,000, compared to net income of $28,935,000 in 2005. Revenue for the 2006 third quarter was $25,055,000, compared to $30,239,000 in 2005. The net loss for the 2006 nine month period was $883,000, compared to net income of $25,524,000 in 2005. Revenue for the 2006 nine month period was $84,528,000, compared to $101,923,000 in 2005. Results for the 2005 periods include a gain of $51,956,000 from the sale of its HE III investment in July 2005.

Revenues

Textile products sales of $25,055,000 decreased by $5,184,000, or 17.1%, in the 2006 third quarter, compared to $30,239,000 in 2005. Sales of $84,528,000 for the nine month period decreased by $17,395,000, or 17.1%, compared to $101,923,000 in 2005. The decreases were principally due to a decrease 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 Brookwood customer, Tennier Industries, Inc. (Tennier) accounted for more than 10% of Brookwood s net sales during both the 2006 and 2005 three month and nine month periods. Its relationship with Tennier is ongoing, however, Brookwood expects reduced sales volumes with Tennier for the balance of 2006. Sales to Tennier, which are included in military sales, were $6,958,000 and $23,653,000 in the 2006 third quarter and nine month periods, respectively, compared to $12,412,000 and $45,898,000 in 2005. Sales to Tennier represented 27.8% and 41.0% of Brookwood s net sales in the 2006 and 2005 quarters, respectively, and 28.0% and 45.0% in the 2006 and 2005 nine month periods, respectively. Sales to another Brookwood customer, ORC Industries, Inc. (ORC), have increased in 2006 and now account for more than 10% of Brookwood s sales. Sales to ORC, which are included in military sales, were $2,754,000 and $10,025,000 in the 2006 third quarter and nine month periods, and represented 11.0% and 11.9% of Brookwood s net sales, respectively.

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

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 in 2006. Military sales accounted for $11,532,000 and $40,449,000 in the 2006 third quarter and nine month periods, respectively, compared to $16,891,000 and $56,653,000 in 2005. Military sales represented 46.0% and 55.9% of Brookwood s net sales in the 2006 and 2005 quarters, respectively, and 47.9% and 55.6% in the 2006 and 2005 nine month periods, respectively.

The Company s former Hallwood Petroleum, LLC subsidiary (HPL) commenced operations in October 2004 as an administrative and management company to facilitate recordkeeping and processing for the energy affiliates. All costs were rebilled to energy affiliates with no profit element. In the 2005 third quarter, the Company determined that its ownership of this pass-through entity created unnecessary complexity. Therefore, HPL was transferred for nominal consideration to officers of the energy affiliates that are not officers of the Company. The transfer was completed in May 2005. Administrative fees from energy affiliates in the 2005 third quarter and nine month periods were $568,000 and $1,499,000, respectively.

Expenses

Textile products cost of sales of $20,935,000 for the 2006 third quarter decreased by $2,825,000, or 11.9%, compared to $23,760,000 in 2005. For the nine month periods, textile products cost of sales of $69,753,000 for 2006 decreased by $10,509,000, or 13.1%, compared to $80,262,000 in 2005. The 2006 decreases principally resulted from reduced sales and changes in product mix, partially offset by increased energy costs of $936,000 and increased freight costs of $318,000. 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 2006 third quarter (16.4% versus 21.4%) and nine month periods (17.5% versus 21.3%), compared to the 2005 periods, principally resulted from changes in product mix and higher energy costs.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Textile products	$ 3,556	$ 3,708	$ 10,335	$ 12,197
Corporate	1,148	1,603	3,650	10,455
Energy				1,499
Total	$ 4,704	$ 5,311	$ 13,985	$ 24,151

Textile products administrative and selling expenses of $3,556,000 for the 2006 third quarter decreased by $152,000, or 4.1%, from the 2005 amount of $3,708,000. For the nine months, selling and administrative expenses were $10,335,000, compared to $12,197,000 in 2005. The decreases were primarily attributable to reduced royalties of $442,000 and $1,672,000, in the 2006 third quarter and nine month periods, respectively. 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 $495,000 and $222,000 in the 2006 and 2005 nine month periods, respectively.

Corporate administrative expenses were $1,148,000 for the 2006 third quarter, compared to $1,603,000 for 2005. For the nine months, corporate expenses were $3,650,000, compared to $10,455,000 in 2005. The decrease of $455,000 for the 2006 third quarter was principally attributable to bonus awards of $436,000 paid in the 2005 quarter. The decrease of $6,805,000 for the nine month period was principally attributable to bonus awards in the 2005 second quarter of $5,000,000 to Mr. Gumbiner and $1,341,000 to those officers of the Company, other than Mr. Gumbiner, who held options to purchase common stock of the Company, in lieu of amounts such option holders would have received had they exercised their options prior to the record date of the May 2005 and August 2005 cash distributions. Professional fees increased by $8,000 for the 2006 quarter and decreased by $150,000 for the 2006 nine month period, compared to the 2005 periods.

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

Administrative costs for the energy affiliates in 2005 related to the Company s former HPL subsidiary and were discontinued in May 2005 (see above).

Other Income (Loss)

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Hallwood Energy	$ (665)	$ 483	$ (1,699)	$ 326
HE III		(8,980)		(8,628)
Total	$ (665)	$ (8,497)	$ (1,699)	$ (8,302)

The 2006 results for Hallwood Energy include production from two wells in the Fort Worth Basin that were sold to Chesapeake, while operations in the West Texas, South Louisiana and East Arkansas regions remain in the exploratory stage at September 30, 2006. The West Texas and East Arkansas areas are currently drilling while the first Louisiana well commenced drilling in October 2006.

The 2005 amounts for Hallwood Energy represent the aggregate results of HE II, HE 4 and Hallwood Exploration for comparability purposes. In connection with the July 2005 disposition of HE III, HE II sold all of its 856 net acre lease holdings in Johnson County, Texas to Chesapeake for $3,000,000. The Company included its pro rata share of the gain from this transaction in the 2005 third quarter.

HE III commenced commercial production and sales of natural gas in June 2004. On July 18, 2005, HE III completed a merger with Chesapeake, under which Chesapeake acquired HE III. The Company s proportionate share of HE III s 2005 loss was principally attributable to compensation expense, in connection with the settlement of profit interests with certain HE III executives, concurrent with the completion of the merger and sale in July 2005. See Note 3.

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

Interest expense was $156,000 and $407,000 in the 2006 third quarter and nine month periods, compared to $134,000 and $436,000 in the 2005 periods, respectively. Interest expense principally relates to Brookwood s Key Bank revolving credit facility. The fluctuations in interest expense were principally due to changes in the average outstanding loan amount, partially offset by increasing interest rates.

Interest and other income was $151,000 and $385,000 in the 2006 third quarter and nine month periods, respectively, compared to $391,000 and $1,238,000 in 2005. The 2006 decreases were principally due to reduced interest income earned on lower balances of cash and cash equivalents and lower income from investments in marketable securities which were sold or matured in 2005.

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

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 September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Federal				
Deferred	$ (227)	$ 678	$ (246)	$ 917
Current	(230)	14,894	(230)	15,551
Sub-total	(457)	15,572	(476)	16,468
State	51	377	428	1,360
Total	$ (406)	$ 15,949	$ (48)	$ 17,828

At September 30, 2006, the net deferred tax asset in the amount of $861,000 was attributable solely to temporary differences, that upon reversal, could be utilized to offset income from operations. The effective federal tax rate in both periods was 35%, while state taxes are determined based upon taxable income apportioned to those states in which the Company does business at their respective tax rates, which vary from 0% to 17%. Income tax expense in the 2005 periods includes a limitation on the deductibility of executive compensation.

Investments in Energy Affiliates

At September 30, 2006, the Company owned approximately 25% (20% after consideration of profit interests) of Hallwood Energy.

On December 31, 2005, the Company had investments in three energy affiliates: HE II, HE 4 and Hallwood Exploration. Investments in two other energy affiliates, HEC and HE III, were sold in December 2004 and July 2005, respectively. Effective December 31, 2005, HE II and Hallwood Exploration were consolidated into HE 4, which was renamed Hallwood Energy.

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

Entity	
HE 4	$ 22,325
HE II	14,011
Hallwood Exploration	4,624
Accumulated equity (loss)	(106)
Total	$ 40,854

In January 2006, the Company invested an additional $2,721,000 in Hallwood Energy.

During the first quarter of 2006, Hallwood Energy entered into a participation agreement (the Participation Agreement) with Activa Resources, Ltd. Under the Participation Agreement, upon Activa s payment of approximately $4,960,000 to Hallwood Energy, which was received in April 2006, Hallwood Energy transferred to Activa an undivided 25% interest in oil and gas leases with respect to 44,219 net acres that Hallwood Energy currently holds in East Arkansas. During the term of the Participation Agreement, Hallwood Energy is designated as operator of the leases. As operator, Hallwood Energy was required to commence actual drilling operations before June 2006 for the first of two initial wells. Hallwood Energy has commenced this drilling. Activa agreed to participate to the extent of its participation interest in the two initial wells, and paid 50% of the first $750,000 incurred for costs associated with the drilling, completion and equipping operations in connection with each of the initial wells.

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

The Participation Agreement also establishes an area of mutual interest (the AMI) potentially covering an area of approximately 184,000 gross acres, which area includes the 44,219 acres. Pursuant to the AMI, Hallwood Energy will have the right to an undivided 75% participation interest, and Activa will have the right to an undivided 25% participation interest, in any additional leases acquired by either of the parties within the AMI. If either party acquires any additional leases covering lands within the AMI, it must offer the other party the right to acquire its participation interest in the leases acquired. The agreement related to the acquisition of additional leases expires in December 2007.

In April 2006, Hallwood Energy sold a 5% limited partner interest to an affiliate of its lender.

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. The sales price of $39,400,000, including reimbursement of certain development and drilling costs and subject to any post closing adjustments, exceeded the book value of the assets sold by $10,600,000. The excess amount was credited to the full cost pool. Completion of the transaction will enable Hallwood Energy to increase its operational focus on its properties in East Arkansas and South Louisiana and reduce its capital requirements in West Texas while retaining a significant interest in the economic potential of the West Texas properties.

In February 2006, Hallwood Energy entered into a $65,000,000 loan facility, and had drawn $40,000,000 as of September 30, 2006. At September 30, 2006, Hallwood Energy was in technical default under the loan facility because, among other things, Hallwood Energy s general and administrative expenses exceeded the maximum amount permitted under the loan facility and Hallwood Energy had not yet completed the mortgage of leases covering at least 350,000 acres in East Arkansas. Hallwood Energy is in the process of completing the mortgages and negotiating with the lender a waiver of all defaults and an amendment of the loan facility. As a result of these efforts, and in connection with an additional $25,000,000 capital contribution expected to be made by its investors in the 2006 fourth quarter, Hallwood Energy expects the lender to waive the defaults, but no agreement has been signed to date and there can be no assurance that the waiver and amendment will be successfully completed. Hallwood Energy currently anticipates drawing the remaining $25,000,000 of the loan facility in 2007 after execution of the loan waiver and amendment agreements.

In early 2006, Hallwood Energy entered into two two-year contracts under which a 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 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. Management does not currently believe that the resolution of this matter will have a material effect on the Company.

In November 2006, Hallwood Energy requested an additional capital contribution in the amount of $25,000,000 from its partners. The Company will be required to fund approximately $6,280,000 to maintain its proportionate interest in Hallwood Energy. The Company will utilize a $470,000 capital contribution receivable to reduce its cash contribution to $5,810,000. In addition, if other investors in Hallwood Energy do not elect to fund their proportionate share of the additional funding, the Company may wish to fund more than its proportionate amount. This contribution will be made from existing cash.

Management of Hallwood Energy is currently evaluating its drilling plans and capital requirements for calendar year 2007. In the early stages of the development of its three operating areas, the drilling plans and capital requirements can vary widely and are dependent upon a number of factors, including the availability and cost of drilling rigs, personnel and other services, regulatory requirements, the success of wells previously drilled by the energy entities and third parties, and other risks and uncertainties described in the Company s Annual Report on Form

10-K for the year ended December 31, 2005 in the section entitled Business Competition, Risks and Other Factors . Hallwood Energy s anticipated capital expenditures and capital requirements through December 31, 2006 have been reduced significantly by the July 2006 sale to Chesapeake, including the impact from the sales proceeds as well as the decrease in future capital expenditures in Texas. In addition, results to date in East Arkansas have been inconclusive. Hallwood Energy may slow down its plan for capital expenditures in this area until it determines how best to exploit its acreage there. Hallwood Energy may also consider additional strategic partnering arrangements for drilling and development.

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 November 1, 2006:

Description	East Arkansas	South Louisiana	Delaware Basin, West Texas (a)	Total
Principal focus	Fayetteville Shale	Salt Dome	Barnett and Woodford Shale	
Initial funding	3rd Quarter 2005	1st Quarter 2004	3rd Quarter 2004	
Company investment				$43,681,000(b)
Company ownership percentage (c)				25%/20%
Net acres held (d)	397,000(e)	(f)	17,300	
Operator	Hallwood Energy	Hallwood Energy	Chesapeake	
Well type: (g)				
Horizontal			1	1
Vertical	6	1	2	9
Well status:				
Producing				
Drilling	1	1	1	3
Evaluating/completing	5		2	7
Net production (Mcf/day)				

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

b) Represents $40,960,000 (including $889,000 of pipe inventory distributed to the Company by HE III in connection with the sale of HE III in July 2005, and recontributed to HE II) from HE

4, HE II and Hallwood Exploration at the December 31, 2005 consolidation date and an additional investment of $2,721,000 in 2006.

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) East Arkansas excludes in excess of 75,000 acres, which were under contract to be acquired, but for which title work has not been completed, some of which management believes will not ultimately be acquired.

f) Hallwood Energy holds options to acquire leases on approximately 20,000 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.

g) 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.

East 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 operating with one rig under long term contract. Hallwood Energy has contracted for five additional rigs beginning sometime between November 2006 and March 2007 to bring the East Arkansas rig count to six by the end of the 2007 first quarter. Hallwood Energy expects three wells to be completed and tested by December 31, 2006.

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 20,000 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 have 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 in October 2006 with a one well commitment and an option on a second well that is expected to be exercised. The first Louisiana well is expected to reach total depth by December 31, 2006. The second rig will start in December 2006 and is under contract for two years. Additional drilling equipment and funding will be assessed and determined based on the results of the initial wells.

Delaware Basin, West Texas

Hallwood Energy sold a 60% interest and transferred operations in these properties to Chesapeake in July 2006. Chesapeake has completed drilling three wells which are awaiting completion/testing. These wells should be completed and tested by the 2007 first quarter. The 2007 budget expectation is that the rig(s) will return in 2007 and drill five gross wells.

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 nine months ended September 30, 2006 were from the two producing wells on these properties.

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

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

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

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

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

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

On July 18, 2005, HE III completed a merger with Chesapeake. The merger agreement provided for a total price of $246,500,000 for all of the HE III production and reserves, as well as the operational and administrative infrastructure in Johnson County, and was subject to reduction for outstanding debt, transaction costs, changes in working capital and certain other matters. After these reductions and adjustments, Chesapeake paid a total of approximately $235,000,000 at the closing, including debt owed by HE III, and additional $3,300,000, as a result of the final working capital adjustment settled in October 2005.

In exchange for its interest in HE III, the Company received a cash payment of $54,850,000 in July 2005 and received an additional $799,000 in November 2005 from the final working capital adjustment. In addition, the Company received a distribution for its proportionate share of certain pipe inventory owned by HE III, with a proportionate carrying value of approximately $889,000, which was contributed to HE II as an additional capital investment. The Company also recorded a receivable in the amount of $470,000 for the settlement of a working capital adjustment with HPL. The receivable will be contributed to Hallwood Energy in November 2006 as an additional capital investment.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

Hallwood Petroleum, LLC. The Company s Hallwood Petroleum, LLC subsidiary (HPL) commenced operation in October 2004 as an administrative and management company to facilitate record keeping and processing for the energy affiliates and has no financial value. All revenues were credited to, and all costs were borne by, the other energy affiliates with no profit element. All assets nominally in the name of HPL were held solely for the benefit of the other energy affiliates. HPL was formed as a subsidiary of the Company as a convenience and it was not intended that it have any financial impact on the Company. In the 2005 third quarter, the Company determined that its ownership of this pass-through entity created unnecessary complexity; therefore HPL was transferred for nominal consideration to officers of the energy affiliates that are not officers of the Company. The transfer was completed in May 2005. HPL was acquired by Hallwood Energy for nominal consideration in connection with the December 31, 2005 consolidation.

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, 2005.

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 ($954,000 prior to March 2005). 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.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
Consulting fees	$ 249	$ 249	$ 747	$ 740
Office space and administrative services	168	112	372	436
Bonus				5,000
Total	$ 417	$ 361	$ 1,119	$ 6,176

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.

Beginning January 1, 2005, 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 month periods ended September 30, 2006 and 2005, HIL reimbursed the Company $34,000 and $30,000, respectively, for such expenses. For the nine month periods ended September 30, 2006 and 2005, HIL reimbursed the Company $107,000 and $80,000, respectively.

Hallwood Energy. Beginning August 1, 2005, Hallwood Energy and its predecessor entities share 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 month periods ended September 30, 2006 and 2005, Hallwood Energy reimbursed the Company $78,000 and $24,000 for such expenses, respectively. For the nine month periods ended September 30, 2006 and 2005, Hallwood Energy reimbursed the Company $247,000 and $24,000, respectively.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

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 September 30, 2006 (in thousands):

	Payments Due During the Year Ending December 31,						
	2006*	2007	2008	2009	2010	Thereafter	Total
Contractual Obligations							
Long term debt	$ 90	$ 281	$ 152	$ 27	$ 7,000	$	$ 7,550
Redeemable preferred stock					1,000		1,000
Operating leases	265	951	924	571	538	1,971	5,220
Total	$ 355	$ 1,232	$ 1,076	$ 598	$ 8,538	$ 1,971	$ 13,770

* For the three months ending December 31, 2006.

Interest costs associated with the Company s debt, which principally bears interest at variable rates, are not a material component of the Company s expenses. 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 September 30, 2006, are $134,000 for the three months ending December 31, 2006 and $523,000, $508,000, $499,000, and $498,000, for the years ending December 31, 2007 through December 31, 2010, respectively.

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 $25,675,000 at September 30, 2006). 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.

Financial Covenants

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

	Quarters Ended
	June 30,

Description	Requirement	September 30. 2006	2006	March 31, 2006	December 31, 2005
Total debt to tangible net worth	must be less than ratio of 1.50	0.77	0.69	0.75	0.65
Net income	must exceed $1.00	Yes	Yes	Yes	Yes

Brookwood was in compliance with its loan covenants under the Key Working Capital Revolving Credit Facility for the first three quarters in 2006 and for all quarters in 2005.

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 $1,189,000 during the 2006 nine month period to $15,459,000 as of September 30, 2006. The principal sources of cash were $3,614,000 provided by operating activities and a net increase in loans payable of $738,000. The primary uses of cash were $2,721,000 for an additional investment in Hallwood Energy and $3,013,000 for property, plant and equipment, principally by Brookwood.

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 September 30, 2006, Brookwood had approximately $15,000,000 of unused borrowing capacity under its revolving line of credit facility and $2,450,000 under its equipment facility.

Brookwood paid cash dividends to the Company of $4,000,000 in the 2006 period through October 31, 2006 and $8,000,000 for all of 2005. In addition, Brookwood made payments to the Company of $500,000 in the 2006 period through October 31, 2006 and $4,552,000 for all of 2005 under its tax sharing agreement. Based upon expected levels of activity at Brookwood, the Company anticipates receiving a further dividend of $2,000,000 and a tax sharing payment of approximately $400,000 in the 2006 fourth quarter. Future cash dividends and tax sharing payments are contingent upon Brookwood s continued compliance with the covenants contained in the Key Bank credit facility. There were no significant additional capital requirements as of September 30, 2006.

Energy. Hallwood Energy anticipates that substantial additional debt or equity funding will be required over the next few years to complete budgeted property acquisition, exploration and development activities. In February 2006, Hallwood Energy entered into a $65,000,000 loan facility, and has drawn $40,000,000 as of September 30, 2006. Hallwood Energy was in technical default of its loan facility at September 30, 2006. Hallwood Energy is in the process of negotiating with the lender a waiver of the defaults and an amendment of the loan facility. If the waiver and amendment are completed, it is anticipated that Hallwood Energy would draw the remaining $25,000,000 of the loan facility in 2007. In July 2006, Hallwood Energy received proceeds of approximately $39,430,000 from the sale of full or partial interests in its Texas properties.

If Hallwood Energy requires additional capital contributions from its partners, the Company will be required to fund approximately 25% of the total capital request to maintain its proportionate interest in Hallwood Energy.

Hallwood Energy has requested a capital contribution from its partners of $25,000,000 to be contributed in December 2006. The Company intends to fund approximately $5,800,000 (net of a capital contribution receivable of $470,000) to maintain its proportionate interest in Hallwood Energy and may contribute additional funds if other investors in Hallwood Energy do not elect to fund their proportionate amount.

The timing and amount of any additional capital contributions for Hallwood Energy are uncertain. Hallwood Energy may determine to seek funding from sources other than existing investors. The Company believes that a contribution up to $15,000,000 can be made from existing cash and cash flow from operations. If Hallwood Energy requests greater equity funding from its current investors, then the Company may be required either to obtain additional funds from operations or from additional debt or equity funding of the Company, or to subscribe to less than its proportionate share of Hallwood Energy s available equity. In addition, if other investors in Hallwood Energy do not elect to fund their proportionate share of any additional funding, the Company may wish to fund more than its proportionate amount, if it has funds available to do so. Additional capital requirements after 2006 may be required. The actual level of Hallwood Energy s capital requirements during 2007 and thereafter, however, will depend on a number of factors that cannot be determined at this time, including future gas prices, costs of field operations, the ability to successfully identify and acquire prospective properties and drill and complete wells, access to gathering and transportation infrastructure, and the availability of alternative sources of capital, such as loans from third parties.

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 operations, the Company believes it has sufficient funds to meet its liquidity needs, although future capital requirements by Hallwood Energy may impact its liquidity.

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, 2005 in the section entitled Business Competition, Risks and Other Factors . These risks and uncertainties are difficult or impossible to predict accurately and many are beyond the control of the Company. Other risks and uncertainties may be described, from time to time, in the Company s periodic reports and filings with the Securities and Exchange Commission.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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 September 30, 2006.

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 September 30, 2006, the Company s total outstanding loans payable of $7,550,000 were comprised of $144,000 of fixed rate debt and $7,406,000 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 $75,000, assuming that outstanding debt remained at current levels.

The Company does not have any derivative financial instruments as of September 30, 2006.

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 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. 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 March 2005 and April 2006, 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. 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. In addition, Brookwood has updated its recordkeeping related to its subsidiary stock option plan.

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

Item

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 the Sarbanes-Oxley Act of 2002.

31.2 Certification of the Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Chief Executive Officer and Chief Financial Officer, pursuant to Section 906 of the 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: November 14, 2006

By: /s/ Melvin J. Melle

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

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
INDEX TO EXHIBITS

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