

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

HALLWOOD GROUP INC
Form 10-Q
August 14, 2003

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

MARK ONE

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

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

FOR THE TRANSITION PERIOD FROM _____ TO _____

FOR THE PERIOD ENDED JUNE 30, 2003

COMMISSION FILE NUMBER: 1-8303

THE HALLWOOD GROUP INCORPORATED
(Exact name of registrant as specified in its charter)

DELAWARE
(State or other jurisdiction of
incorporation or organization)

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

3710 RAWLINS, SUITE 1500
DALLAS, TEXAS
(Address of principal executive offices)

75219
(Zip Code)

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

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

TITLE OF CLASS	NAME OF EACH EXCHANGE ON WHICH REGISTERED
Common Stock (\$0.10 par value)	American Stock Exchange
10% Collateralized Subordinated Debentures Due July 31, 2005	New York Stock Exchange

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

TITLE OF CLASS

Series B Redeemable Preferred Stock

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

YES NO

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

YES NO

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

1,326,343 shares of Common Stock, \$.10 par value per share, were outstanding at August 8, 2003.

THE HALLWOOD GROUP INCORPORATED

TABLE OF CONTENTS

ITEM NO.	PART I - FINANCIAL INFORMATION
1	Financial Statements (Unaudited): Condensed Consolidated Balance Sheets as of June 30, 2003 and December 31, 2002..... Condensed Consolidated Statements of Income for the Six Months Ended June 30, 2003 and 2002..... Condensed Consolidated Statements of Income for the Three Months Ended June 30, 2003 and 2002..... Condensed Consolidated Statements of Comprehensive Income for the Six Months Ended June 30, 2003 and 2002 and Three Months Ended June 30, 2003 and 2002..... Condensed Consolidated Statements of Changes in Stockholders' Equity for the Six Months Ended June 30, 2003 Condensed Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2003 and 2002..... Notes to Condensed Consolidated Financial Statements.....
2	Managements's Discussion and Analysis of Financial Condition and Results of Operations.....
3	Quantitative and Qualitative Disclosures about Market Risk.....
4	Controls and Procedures and Internal Controls.....
	PART II - OTHER INFORMATION
1 to 6	Other Information, Exhibits and Reports on Form 8-K..... Signature Page..... Index to Exhibits.....

THE HALLWOOD GROUP INCORPORATED

CONDENSED CONSOLIDATED BALANCE SHEETS
(DOLLARS IN THOUSANDS)
(UNAUDITED)

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

ASSETS

	JUNE 30, 2003	DECEMBER 31, 2002
	-----	-----
REAL ESTATE		
Investments in HRP	\$ 15,938	\$ 13,525
Receivables and other assets		
Related parties	422	732
Other	36	60
	-----	-----
	16,396	14,317
TEXTILE PRODUCTS		
Inventories	20,611	18,913
Receivables	18,718	15,743
Property, plant and equipment, net .	9,027	9,315
Prepays, deposits and other assets	442	548
	-----	-----
	48,798	44,519
OTHER		
Deferred tax asset, net	6,972	4,221
Investment in HEC	4,333	3,313
Cash and cash equivalents	3,486	1,377
Prepays, deposits and other assets		
Other	337	317
Related parties	66	140
Hotel assets held for use	307	362
Restricted cash	--	982
	-----	-----
.....	15,501	10,712
	-----	-----
TOTAL	\$ 80,695	\$ 69,548
	=====	=====

See accompanying notes to condensed consolidated financial statements.

Page 3

THE HALLWOOD GROUP INCORPORATED

CONDENSED CONSOLIDATED BALANCE SHEETS
(DOLLARS IN THOUSANDS)
(UNAUDITED)

LIABILITIES AND STOCKHOLDERS' EQUITY

	JUNE 30, 2003	DECEMBER 2002
	-----	-----
REAL ESTATE		
Accounts payable and accrued expenses	\$ 196	\$ 1
TEXTILE PRODUCTS		
Loans payable	15,436	13

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

Accounts payable and accrued expenses	12,883	10
	-----	-----
	28,319	24
OTHER		
Interest, litigation and other accrued expenses	7,233	1
10% Collateralized Subordinated Debentures	6,598	6
Loans payable	4,372	2
Separation Agreement obligations	3,750	4
Deferred revenue - noncompetition agreement	2,215	3
Redeemable preferred stock, Series B	1,000	1
Hotel accounts payable and accrued expenses	984	
Capital lease obligations	808	1
	-----	-----
	26,960	21
TOTAL LIABILITIES	55,475	46
STOCKHOLDERS' EQUITY		
Preferred stock, 250,000 shares issued and outstanding as Series B	--	
Common stock, issued 2,396,103 shares at both dates; outstanding 1,361,343 shares at both dates	240	
Additional paid-in capital	54,429	54
Accumulated deficit	(14,283)	(16)
Accumulated other comprehensive income	164	
Treasury stock, 1,034,760 shares at both dates; at cost	(15,330)	(15)
	-----	-----
TOTAL STOCKHOLDERS' EQUITY	25,220	23
	-----	-----
TOTAL	\$ 80,695	\$ 69
	=====	=====

See accompanying notes to condensed consolidated financial statements.

Page 4

THE HALLWOOD GROUP INCORPORATED

CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)
(UNAUDITED)

	SIX MONTHS ENDED JUNE 30,	
	2003	2002
	-----	-----
REAL ESTATE		
Fees		
Related parties	\$ 2,288	\$ 2,378
Other	110	104
Equity income (loss) from investments in HRP	(347)	947
	-----	-----
	2,051	3,429
Litigation expense	3,602	--

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

Administrative expenses	538	567
Amortization	336	336
	-----	-----
	4,476	903
	-----	-----
Income (loss) from real estate operations	(2,425)	2,526
TEXTILE PRODUCTS		
Sales		
Trade	49,065	34,771
Related party	--	8,981
Equity income from joint venture	--	723
	-----	-----
	49,065	44,475
Cost of sales	39,083	37,204
Administrative and selling expenses	7,069	5,614
Interest	332	374
	-----	-----
	46,484	43,192
	-----	-----
Income from textile products operations	2,581	1,283
OTHER		
Amortization of deferred revenue - noncompetition agreement	1,208	1,208
Hotel revenue	704	898
Equity income (loss) from investment in HEC	107	(77)
Interest and other income	2	308
	-----	-----
	2,021	2,337
Administrative expenses	949	974
Hotel expenses	919	930
Interest expense	423	430
	-----	-----
	2,291	2,334
	-----	-----
Other income (loss)	(270)	3
	-----	-----
Income (loss) from continuing operations before income taxes	(114)	3,812
Income tax benefit (expense)	2,298	(1,354)
	-----	-----
Income from continuing operations	2,184	2,458

See accompanying notes to condensed consolidated financial statements.

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

	SIX MONTHS ENDED JUNE 30,	
	2003	2002
	-----	-----
Income from discontinued hotel operations, net of tax	\$ --	\$ 3,734
	-----	-----
Income before cumulative effect of change in accounting principle	2,184	6,192
Income from cumulative effect of change in accounting principle	--	568
	-----	-----
NET INCOME	2,184	6,760
Preferred stock dividend	(50)	(50)
	-----	-----
NET INCOME AVAILABLE TO COMMON STOCKHOLDERS	\$ 2,134	\$ 6,710
	=====	=====
PER COMMON SHARE		
BASIC		
Income from continuing operations after preferred dividend	\$ 1.57	\$ 1.77
Income from discontinued operations	--	2.74
Income from cumulative effect of change in accounting principle ..	--	0.42
	-----	-----
Net income available to common stockholders	\$ 1.57	\$ 4.93
	=====	=====
ASSUMING DILUTION		
Income from continuing operations after preferred dividend	\$ 1.56	\$ 1.66
Income from discontinued operations	--	2.54
Income from cumulative effect of change in accounting principle ..	--	0.38
	-----	-----
Net income available to common stockholders	\$ 1.56	\$ 4.58
	=====	=====
WEIGHTED AVERAGE SHARES OUTSTANDING		
Basic	1,361	1,361
	=====	=====
Assuming dilution	1,372	1,470
	=====	=====

See accompanying notes to condensed consolidated financial statements.

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

	THREE MONTHS ENDED JUNE 30,	
	2003	2002
	-----	-----
REAL ESTATE		
Fees		
Related parties	\$ 1,081	\$ 1,266
Other	70	97
Equity income (loss) from investments in HRP	(663)	414
	-----	-----
	488	1,777
Litigation expense	3,602	--
Administrative expenses	282	347
Amortization	168	168
	-----	-----
	4,052	515
	-----	-----
Income (loss) from real estate operations	(3,564)	1,262
TEXTILE PRODUCTS		
Sales		
Trade	24,266	18,415
Related party	--	4,516
Equity income from joint venture	--	149
	-----	-----
	24,266	23,080
Cost of sales	18,873	19,151
Administrative and selling expenses	3,517	2,945
Interest	183	208
	-----	-----
	22,573	22,304
	-----	-----
Income from textile products operations	1,693	776
OTHER		
Amortization of deferred revenue - noncompetition agreement	604	604
Hotel revenue	367	458
Equity income (loss) from investment in HEC	56	(36)
Interest and other income	1	4
	-----	-----
	1,028	1,030
Administrative expenses	521	592
Hotel expenses	471	493
Interest expense	220	225
	-----	-----
	1,212	1,310
	-----	-----
Other income (loss)	(184)	(280)
	-----	-----
Income (loss) from continuing operations before income taxes	(2,055)	1,758
Income tax benefit (expense)	2,886	(616)
	-----	-----
Income from continuing operations	831	1,142

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

See accompanying notes to condensed consolidated financial statements.

Page 7

THE HALLWOOD GROUP INCORPORATED

CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)
(UNAUDITED)

	THREE MONTHS ENDED JUNE 30,	
	2003	2002
	-----	-----
Income from discontinued hotel operations, net of tax	\$ --	\$ 2,258
	-----	-----
NET INCOME	831	3,400
Preferred stock dividend	(50)	(50)
	-----	-----
NET INCOME AVAILABLE TO COMMON STOCKHOLDERS	\$ 781	\$ 3,350
	=====	=====
PER COMMON SHARE		
BASIC		
Income from continuing operations after preferred dividend	\$ 0.57	\$ 0.80
Income from discontinued operations	--	1.66
	-----	-----
Net income available to common stockholders	\$ 0.57	\$ 2.46
	=====	=====
ASSUMING DILUTION		
Income from continuing operations after preferred dividend	\$ 0.56	\$ 0.80
Income from discontinued operations	--	1.66
	-----	-----
Net income available to common stockholders	\$ 0.56	\$ 2.46
	=====	=====
WEIGHTED AVERAGE SHARES OUTSTANDING		
Basic	1,361	1,361
	=====	=====
Assuming dilution	1,399	1,361
	=====	=====

See accompanying notes to condensed consolidated financial statements.

Page 8

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

THE HALLWOOD GROUP INCORPORATED

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (IN THOUSANDS) (UNAUDITED)

	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,
	2003	2002	2003
NET INCOME	\$ 831	\$ 3,400	\$ 2,184
Other Comprehensive Income (Loss)			
Pro rata share of other comprehensive income (loss) from equity investments			
Amortization of interest rate swap	(14)	(15)	(27)
COMPREHENSIVE INCOME	\$ 817	\$ 3,385	\$ 2,157

See accompanying notes to condensed consolidated financial statements.

Page 9

THE HALLWOOD GROUP INCORPORATED

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY (IN THOUSANDS) (UNAUDITED)

	COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	ACCUMULATED DEFICIT	ACCUMULATED OTHER COMPREHENSIVE INCOME
	SHARES	PAR VALUE			
BALANCE, JANUARY 1, 2003	2,396	\$ 240	\$ 54,452	\$ (16,417)	\$ 191
Net income				2,184	
Pro rata share of partners' capital transactions from equity investment:					
Exercise of stock options			(23)		
Amortization of interest rate swap					(27)
Cash dividend on preferred stock				(50)	
BALANCE, JUNE 30, 2003	2,396	\$ 240	\$ 54,429	\$ (14,283)	\$ 164

See accompanying notes to condensed consolidated financial statements.

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

Page 10

THE HALLWOOD GROUP INCORPORATED

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)
(UNAUDITED)

	SIX MONTHS ENDED JUNE 30,	
	2003	2002
	-----	-----
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 2,184	\$ 6,760
Adjustments to reconcile net income to net cash provided by operating activities:		
Accrued litigation expense	3,602	--
Deferred tax expense (benefit)	(2,751)	1,086
Amortization of deferred revenue - noncompetition agreement	(1,208)	(1,208)
Depreciation and amortization	1,139	1,026
Decrease in restricted cash	982	--
Equity income/loss from investments in HRP	347	(947)
Equity income/loss from investment in HEC	(107)	77
Amortization of deferred gain from debenture exchange	(27)	(25)
Equity income from textile products joint venture	--	(723)
Income from cumulative effect of changes in accounting principle	--	(568)
Net change in textile products assets and liabilities	(2,487)	503
Net change in other assets and liabilities	(979)	(470)
Discontinued operations:		
Net change in other hotel assets and liabilities	(400)	242
Gain from extinguishment of hotel debt	--	(5,789)
Deferred tax expense	--	1,800
	-----	-----
Net cash provided by operating activities	295	1,764
CASH FLOWS FROM INVESTING ACTIVITIES		
Investment in HEC common stock	(912)	(1,500)
Investments in textile products property and equipment	(460)	(369)
Investment in hotel held for use	--	(17)
	-----	-----
Net cash (used in) investing activities	(1,372)	(1,886)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from bank borrowings and loans payable	4,251	3,429
Repayment of bank borrowings and loans payable	(1,015)	(3,714)
Payment of cash dividend on preferred stock	(50)	(50)
Payment of deferred loan costs	--	(86)
	-----	-----
Net cash provided by (used in) financing activities	3,186	(421)
	-----	-----
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	2,109	(543)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	1,377	3,006

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 3,486	\$ 2,463
	=====	=====

See accompanying notes to condensed consolidated financial statements.

Page 11

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2003

(UNAUDITED)

NOTE 1 -- INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS, NEW ACCOUNTING PRONOUNCEMENTS AND RECLASSIFICATIONS

Interim Condensed Consolidated Financial Statements. The interim condensed consolidated financial statements of The Hallwood Group Incorporated (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, in the opinion of management, all adjustments considered necessary for a fair presentation have been included. These condensed 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, 2002.

Continuing Operations. The Company is a holding company that classifies its primary continuing business operations into two segments; real estate and textile products. During 2002, the Company re-entered the energy business as a 28% owner in a private energy company, Hallwood Energy Corporation ("HEC"), but HEC is not considered a material business segment.

The Company's real estate activities are conducted primarily through wholly-owned subsidiaries. One of the subsidiaries serves as the general partner of Hallwood Realty Partners, L.P. ("HRP"), a publicly traded master limited partnership. Revenues are generated through the Company's pro rata share of earnings of HRP using the equity method of accounting and the receipt of management fees, leasing commissions and other fees from HRP and third parties.

The textile products operations are conducted through the Company's wholly owned Brookwood Companies Incorporated subsidiary ("Brookwood"). Brookwood is an integrated textile service 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"), produces advanced breathable, waterproof laminate fabrics for military applications. Continued development of these fabrics for military, industrial and consumer applications is a key element of Brookwood's business plan.

The Company invested \$3,500,000 in HEC during 2002 and an additional \$1,051,000 in 2003 (including \$139,000 in July 2003). HEC is presently in the development stage, having drilled and completed nine test wells in the Barnett Shale Formation of Johnson County, Texas. The Company owns approximately 28% of HEC and accounts for the investment using the equity method of accounting. Certain of the Company's officers and directors are investors in HEC. See Note 3.

Discontinued Operations. In December 2000, the Company discontinued its

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

hotel segment, which at that time consisted of five hotel properties. Two hotels were disposed of in 2001, one hotel was sold in January 2002 and the lender completed a foreclosure on one hotel in May 2002. The Company continues to operate a leasehold interest in one hotel.

New Accounting Pronouncements. Statement of Financial Accounting Standards No. 148 - Accounting for Stock Based Compensation - Transition and Disclosure, an Amendment of FASB Statement No. 123 ("SFAS No. 148"), was issued in December 2002. This statement provides new transition methods if an entity adopts the fair value-based method of valuing stock-based compensation suggested in SFAS No. 123 - Accounting for Stock Based Compensation, as well as requiring additional disclosures in interim and annual financial statements. No options have been granted since 2000. As all options were fully vested as of December 31, 2000, there is no difference between the historical operations and pro forma operations for the periods presented herein had the expense provisions of SFAS No. 123 been adopted.

Statement of Financial Accounting Standards No. 149 - Amendment of Statement 133 on Derivative Instruments and Hedging Activities ("SFAS No. 149"), was issued in April 2003. SFAS No. 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133. The statement is generally effective for contracts entered into or modified after June 30, 2003. The Company is evaluating the impact of this statement and does not believe that it will have a material impact on its financial results.

Page 12

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 JUNE 30, 2003
 (UNAUDITED)

Statement of Financial Accounting Standards No. 150 - Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity ("SFAS No. 150"), was issued in May 2003. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within the scope of SFAS No. 150 as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. SFAS No. 150 is generally effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. In accordance with SFAS No. 150, the Company has reclassified its redeemable Series B Preferred Stock as a liability at the balance sheet dates.

Reclassifications. Certain reclassifications have been made to prior year amounts to conform to the classifications used in the current year.

NOTE 2 -- INVESTMENTS IN HRP (DOLLAR AMOUNTS IN THOUSANDS)

DESCRIPTION OF INVESTMENT	AS OF JUNE 30, 2003		AMOUNT AT WHICH CARRIED AT		INCOME (LOSS) FOR SIX MONTHS ENDED JUNE 30,	
	NUMBER OF UNITS	COST OR ASCRIBED VALUE	JUNE 30, 2003	DECEMBER 31, 2002	2003	2002
-----	-----	-----	-----	-----	-----	-----

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

HALLWOOD REALTY PARTNERS, L.P.						
- General partner interest	--	\$ 8,650	\$ 998	\$ 1,350	\$ (14)	\$
- Limited partner interest	330,432	11,787	14,940	12,175	(333)	
		-----	-----	-----	-----	-----
Totals		\$ 20,437	\$ 15,938	\$ 13,525	\$ (347)	\$
		=====	=====	=====	=====	=====

At June 30, 2003, Hallwood Realty, LLC ("Hallwood Realty") and HWG, LLC, wholly owned subsidiaries of the Company, owned a 1% general partner interest and a 21% limited partner interest in its HRP affiliate, respectively. The Company accounts for its investment in HRP using the equity method of accounting. In addition to recording its share of HRP's net income (loss), the Company also records non-cash adjustments for the elimination of intercompany profits with a corresponding adjustment to equity income (loss), its pro rata share of HRP's partner capital transactions with corresponding adjustments to additional paid-in capital and its pro rata share of HRP's comprehensive income (loss). The cumulative amount of such non-cash adjustments, from the original date of investment through June 30, 2003, resulted in a \$1,965,000 decrease in the carrying value of the HRP investment. Prior to January 1, 2002, the Company recorded amortization of the amount that the Company's share of the underlying equity in net assets of HRP exceeded its investment on the straight line basis over nineteen years. In accordance with Statement of Financial Accounting Standards No. 142 - Goodwill and Other Intangibles ("SFAS No. 142"), the unamortized amount of such "negative goodwill" in the amount of \$568,000, as of January 1, 2002, was recorded as income from cumulative effect of a change in accounting principle.

The carrying value of the Company's investment in the general partner interest of HRP includes the value of intangible rights to provide asset management and property management services. The Company amortizes that portion of the general partner interest ascribed to the management rights. For the six months ended June 30, 2003 and 2002 such amortization was \$336,000 in each period. At June 30, 2003, the remaining unamortized cost was \$224,000.

As discussed in Note 12, the Delaware Court of Chancery rendered its decision after remand regarding certain litigation involving the Company in July 2003. The court determined that the defendants, including the Company, should pay to HRP a judgment of \$2,988,000, plus prejudgment interest of \$3,762,000 from August 1995. The judgment amount, which represented the court's determination of an underpayment by the Company for certain limited partnership units purchased by the Company in 1995 from HRP, is in addition to a judgment amount of \$3,417,000 in the Court's original ruling, was considered additional purchase price and was added to the Company's investment in the limited partnership units. The interest component of the judgment was recorded as litigation expense, net of the Company's pro rata share of that amount which is expected to be recorded as income by HRP. The Company also recorded its pro rata share of \$3,000,000 in attorney's fees payable by HRP to plaintiff's attorneys, in accordance with the court's final order and judgment, expected to be recorded as an expense by HRP. The Company anticipates making a \$5,000,000 payment against this obligation in August 2003. The remaining balance would bear interest at the statutory rate of 7%.

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

(UNAUDITED)

The Company has pledged 300,397 HRP limited partner units to collateralize the Term Loan and Revolving Credit Facility and the Amended and Restated Credit Agreement and the remaining 30,035 units to secure all of the capital leases. See Note 4

The quoted market price per HRP limited partner unit and the Company's carrying value per unit (AMEX symbol HRY) at June 30, 2003 were \$101.00 and \$45.21, respectively. The general partner interest is not publicly traded.

Tender Offer. On May 1, 2003, High River Limited Partnership, an affiliate of Carl C. Icahn, announced its unsolicited tender offer for any and all of the outstanding limited partnership units of HRP at \$100 per unit. In May 2003, HRP management, the board of directors of Hallwood Realty, and certain professional advisors evaluated the offer and advised unitholders to reject the offer as inadequate.

On July 29, 2003, and in a subsequent letter addressed to the board of directors of Hallwood Realty, Mr. Icahn announced a purported proposal to purchase HRP in a merger transaction for an aggregate purchase price of \$222 million, subject to existing debt. On August 1, 2003, at the direction of its board of directors, Hallwood Realty sent a letter to Mr. Icahn stating that HRP has engaged Morgan Stanley & Co. Incorporated to initiate discussions with parties interested in participating in a transaction with HRP and stating that if Mr. Icahn is interested in participating in that process, he should contact Morgan Stanley. The unsolicited tender offer has subsequently been extended to September 5, 2003.

The board of directors of Hallwood Realty has authorized its advisors to continue its evaluation of potential alternatives to the tender offer, including, without limitation, to initiate discussions with prospective parties interested in participating in a transaction with HRP at prices and on terms which the Hallwood Realty board believes would be in the best interest of all partners. Such transaction may include, without limitation, an extraordinary transaction, such as a merger, reorganization or liquidation, involving HRP or any of its subsidiaries or a purchase, sale or transfer of a material amount of assets by HRP of any of its subsidiaries. There can be no assurance, however, that HRP will be able to generate interest in any such transaction.

NOTE 3 -- INVESTMENT IN HEC (DOLLAR AMOUNTS IN THOUSANDS)

DESCRIPTION OF INVESTMENT	AS OF JUNE 30, 2003		AMOUNT AT WHICH CARRIED AT		INCOME (LOSS) FOR SIX MONTHS ENDED	
	NUMBER OF SHARES	COST OR ASCRIBED VALUE	JUNE 30, 2003	DECEMBER 31, 2002	JUNE 30, 2003	2002
HALLWOOD ENERGY CORPORATION						
Common stock.....	2,206	\$ 4,412	\$ 4,333	\$ 3,313	\$ 107	\$

The Company owns approximately 28% of HEC. It accounts for the investment using the equity method of accounting and records its pro rata share of HEC's net income (loss), stockholders' equity transactions and comprehensive income (loss) adjustments, if any.

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

The Company invested \$3,500,000 in HEC during 2002 and an additional \$1,051,000 in 2003 (including \$139,000 in July 2003 when the Company purchased 35 additional shares from an existing shareholder). HEC is presently in the development stage, having drilled and completed nine test wells in the Barnett Shale formation of Johnson County, Texas. After constructing a gas gathering system, HEC commenced commercial production and sales from three of the nine wells in February 2003. Currently, eight wells are producing and one well has been temporarily abandoned. Aggregate production, including royalty owner share and minor working interest participation, rose to 3.0 million cubic feet of gas per day during the first week of May 2003, and was approximately 2.6 million cubic feet of gas per day at August 8, 2003. The reduction in production is due in part to the natural decline experienced in Barnett Shale wells, coupled with a temporary slow down in drilling activity between May and July 2003.

In addition to the above, HEC has drilled the Worthington #1, which will serve as a Texas Railroad Commission Class 1 disposal well and will be used to accommodate disposed water for HEC as well as third parties. Additional

Page 14

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 JUNE 30, 2003
 (UNAUDITED)

operations in progress at July 31, 2003 include the drilling of two additional Barnett Shale wells. HEC anticipates completion operations to commence on these properties by the middle of August 2003.

HEC currently plans to drill between 10 and 20 wells during the balance of 2003; however, this number may vary based upon a variety of operational and economic conditions. Whether HEC drills 10 or 20 additional wells this year, additional capital will be required. HEC currently anticipates that it will solicit equity contributions from its shareholders in combination with secured borrowings to meet its capital requirements. Depending on the level of borrowings, coupled with the ultimate level of well development activity, HEC may request from its shareholders additional equity contributions over the next six to eight months of approximately \$5,000,000. Based on the Company's current ownership percentage, if approved by the Company's board of directors, its equity contribution may total approximately \$1,400,000.

HEC holds oil and gas leases covering approximately 34,500 gross and 30,300 net acres of undeveloped leasehold, predominantly in Johnson County, Texas, as of July 31, 2003.

Certain of the Company's officers and directors are investors in HEC.

NOTE 4 -- LOANS PAYABLE

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

	JUNE 30, 2003	DECEMBER 31, 2002
	-----	-----
Textile Products		
Revolving credit facility, prime + 0.25% or		
Libor + 3.00%, due January 2004	\$ 12,451	\$ 10,000

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

Acquisition credit facility, prime + 1.00% or		
Libor + 3.25%, due January 2004	1,000	1,000
Equipment term loan, 9.37% fixed, due October 2005	525	623
Equipment term loan, 5.10% fixed, due March 2007	419	469
Equipment term loan, 4.67% fixed, due December 2007	276	298
Equipment term loan, libor + 3.25%, due April 2008	142	--
	-----	-----
Sub total	14,813	12,390
Subordinated secured promissory note, prime rate, due July 2004	425	596
Subordinated promissory note, non-interest bearing, due February 2005	198	261
	-----	-----
	15,436	13,247
Other		
Loans payable		
Revolving credit facility, prime + 0.50% or		
Libor + 3.25%, due April 2005	2,300	500
Term loan, 7% fixed, due April 2005	1,836	2,317
Promissory note, non-interest bearing, due December 2004 ...	236	--
	-----	-----
Sub total	4,372	2,817
Capital lease obligations, 12.18% fixed, due December 2004 ...	808	1,066
	-----	-----
	5,180	3,883
	-----	-----
Total	\$ 20,616	\$ 17,130
	=====	=====

Further information regarding loans payable is provided below:

Page 15

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2003
(UNAUDITED)

Textile Products

Revolving Credit Facility. The Company's Brookwood subsidiary has a revolving credit facility in an amount up to \$17,000,000 with Key Bank National Association (the "Key Credit Agreement"). Availability for direct borrowings and letter of credit obligations under the Key Credit Agreement are limited to the lesser of the facility amount or the borrowing base, as defined in the agreement. Borrowings are collateralized by accounts receivable, inventory imported under trade letters of credit, certain finished goods inventory, machinery and equipment and all of the issued and outstanding capital stock of Brookwood and its subsidiaries. The Key Credit Agreement has a maturity date of January 2, 2004, bears interest at Brookwood's option of prime + 0.25% (4.50% at June 30, 2003) or Libor plus 3.00%, contains various covenants, including maintenance of certain financial ratios, restrictions on payment of dividends and repayment of debt or cash transfers to the Company. The outstanding balance at June 30, 2003 was \$12,451,000.

Cash dividends and tax sharing payments to the Company are contingent upon Brookwood's compliance with the covenants contained in the Key Credit Agreement. Brookwood was not in compliance with its minimum net income covenant at December 31, 2002. Brookwood obtained a waiver for this violation from the lender and

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

believes it will be in compliance with all of its covenants for 2003. The Key Credit Agreement does not contain a minimum net income covenant for 2003. At June 30, 2003, Brookwood was in compliance with its loan covenants.

As of June 30, 2003, Brookwood had approximately \$3,090,000 of borrowing base availability.

Acquisition Credit Facility. The Key Credit Agreement provides for a \$2,000,000 acquisition revolving credit line. This facility bears interest at Brookwood's option of prime plus 1.00% (5.25% at June 30, 2003) or Libor plus 3.25%. Brookwood has borrowed \$1,000,000 under this facility.

Equipment Credit Facility and Term Loans. The Key Credit Agreement provides for a \$2,000,000 equipment revolving credit line. The facility bears interest at Libor plus 2.75%. In May 2000, Brookwood borrowed \$1,000,000 under this credit line, which was converted into a term loan, at a fixed rate of 9.37%, with a maturity date of October 2005. In February and December 2002, Brookwood borrowed an additional \$542,000 and \$298,000 under this facility and converted those amounts into term loans, at fixed rates of 5.10% and 4.67%, with maturities of March and December 2007, respectively. In April 2003, Brookwood borrowed \$142,000 at libor + 3.25% due April 2008. Brookwood has \$638,000 availability under this facility. The outstanding balance at June 30, 2003 was \$1,362,000.

The outstanding balance of the combined Key Bank credit facilities at June 30, 2003 was \$14,813,000.

Subordinated Secured Promissory Note. Brookwood was a 50% partner in STA with an unrelated third party until September 2002. In September 2002, STA purchased the shares owned by the unrelated third party partner, making STA a wholly owned Brookwood subsidiary, and gave the seller a promissory note in the amount of \$596,000. The note bears interest at the prime rate (4.25% at June 30, 2003), requires a quarterly payment of approximately \$85,000 and is due in July 2004. The outstanding balance at June 30, 2003 was \$425,000.

Subordinated Promissory Note. As part of the purchase price related to the acquisition of an entity in 2000, Brookwood gave the seller a \$375,000 subordinated promissory note dated March 2002. The interest free note is being fully amortized over 36 months and has a maturity date of February 2005. The outstanding balance at June 30, 2003 was \$198,000.

The Brookwood revolving and acquisition facilities, with a combined balance of \$13,451,000 at June 30, 2003, mature in January 2004. The Company intends to extend or refinance these facilities prior to their maturity.

Other

Term Loan and Revolving Credit Facility. In March 2002, the Company and its HWG, LLC subsidiary entered into a \$7,000,000 credit agreement with First Bank & Trust, N.A. The facility is comprised of a \$3,000,000 term loan

Page 16

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2003
(UNAUDITED)

and a \$4,000,000 revolving credit facility (the "Term Loan and Revolving Credit Facility").

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

The revolving credit facility bears interest at the Company's option of prime plus 0.50%, or Libor plus 3.25%, and matures April 2005. The interest rate is 4.75% at June 30, 2003. The Company borrowed an additional \$800,000 under the facility in March 2003 and \$1,000,000 in June 2003 and therefore had \$1,700,000 of unused borrowing capacity at June 30, 2003. The Company borrowed an additional \$500,000 in July 2003 in connection with the acquisition of treasury stock. The outstanding principal balance on the revolving credit facility at June 30, 2003 was \$2,300,000.

Term loan proceeds were used in part to repay a \$1,500,000 convertible loan from a stockholder. The term loan bears interest at a fixed rate of 7%, matures April 2005 and is fully amortizing requiring a monthly payment of \$92,631. The outstanding principal balance of the term loan at June 30, 2003 was \$1,836,000.

Amended and Restated Credit Agreement. On July 28, 2003, the Company and its HWG, LLC subsidiary entered into an amended and restated credit agreement with First Bank and Trust, N.A. (the "Amended and Restated Credit Agreement"). The facility provides for an additional \$3,000,000 term loan and an additional \$5,000,000 credit facility. The proceeds of the new \$3,000,000 term loan ("Special Purpose Term Loan") are restricted and must be used solely to exercise the option associated with the Separation Agreement discussed in Note 6. The Special Purpose Term Loan bears interest at a fixed rate of 6%, matures May 2005 and requires a monthly payment of \$48,365. The proceeds of the new \$5,000,000 credit facility ("Special Purpose Credit Facility") are restricted and must be used solely to pay a portion of the litigation judgment in the Gotham Partners v. Hallwood Realty Partners, L.P., et al matter discussed in Note 12. The Special Purpose Credit Facility bears interest at the Company's option of prime plus 0.50%, or Libor plus 3.25%, but cannot be less than 4.25%, and matures May 2005. The Special Purpose Credit Facility does not require principal payments; however, interest is payable monthly.

Proceeds of the two new facilities must be drawn down prior to August 26, 2003. The Amended and Restated Credit Agreement requires certain mandatory repayments upon the occurrence of various events, including new debt offerings and the disposition of certain of the Company's major investments.

Collateral for the Term Loan and Revolving Credit Facility and the Amended and Restated Credit Agreement is 300,397 HRP limited partner units. The credit agreements contain various financial and non-financial covenants, including the maintenance of financial ratios, restrictions on new indebtedness and the payment of dividends. The Company was in compliance with its loan covenants under the Term Loan and Revolving Credit Facility and Amended and Restated Credit Agreement for all interim periods during 2003.

Promissory Note. In connection with the settlement of a lawsuit regarding the Company's former Embassy Suites hotel in Oklahoma City, Oklahoma, the Company issued a non-interest bearing promissory note in June 2003, in the amount of \$250,000 payable in equal monthly installments over 18 months. The outstanding balance at June 30, 2003 was \$236,000.

Capital Lease Obligations. During 1999, the Company's Brock Suite Hotels subsidiaries entered into three separate five-year capital lease agreements for furniture, fixtures and building improvements at a cost of \$2,085,000 for three GuestHouse Suites Plus properties. The Company has pledged 30,035 HRP limited partner units as additional collateral to secure the leases. The lease terms commenced January 2000 and expire in December 2004. The combined monthly lease payment is \$46,570 and the effective interest rate is 12.18%. The outstanding principal balance at June 30, 2003 was \$808,000.

NOTE 5 -- 10% COLLATERALIZED SUBORDINATED DEBENTURES

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

The Company has an issue of 10% Collateralized Subordinated Debentures ("10% Debentures") outstanding due July 31, 2005. The 10% Debentures are listed on The New York Stock Exchange. For financial reporting purposes a pro-rata portion of an unamortized gain in the original amount of \$353,000 was allocated to the 10% Debentures from a previous debenture issue, and is being amortized over its term. As a result, the effective interest rate is 8.9%.

Page 17

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2003

(UNAUDITED)

The 10% Debentures are secured by a junior lien on the capital stock of Brookwood. Balance sheet amounts are detailed below (in thousands):

DESCRIPTION	JUNE 30, 2003	DECEMBER 31, 2002
10% Debentures (face amount)	\$ 6,468	\$ 6,468
Unamortized gain, net of accumulated amortization	130	157
Totals	\$ 6,598	\$ 6,625

NOTE 6 -- SEPARATION AGREEMENT

In 1999, the Company entered into a separation agreement (the "Separation Agreement") with a former officer and director. The Separation Agreement provided that a former officer and director and related trust exchange their 24% stock ownership in the Company for 20% of the Company's limited partner interest in HRP, 20% of the Company's common stock interest in the former Hallwood Energy Corporation ("Former HEC"), all of the Company's interest in its condominium hotel business and future cash payments contingent on the net cash flow from the Company's real estate management activities, that being the lesser of 20% of the net cash flow from its real estate management activities for the preceding quarter or \$125,000. These future cash payments are subject to termination in certain circumstances. The Separation Agreement obligation of \$3,750,000 and \$4,000,000 at June 30, 2003 and December 31, 2002, respectively, represents the estimated future cash payments to the trust through the period ending December 2004. The Company has an option to extinguish the future cash payments at any time prior to December 2004 upon the payment of \$3,000,000.

As discussed in Note 4, the Company entered into an Amended and Restated Credit Agreement in July 2003, which provides for a Special Purpose Term Loan in the amount of \$3,000,000 to be used to exercise the aforementioned option. The Company anticipates recording a debt extinguishment gain to the extent that the carrying amount of the Separation Agreement obligations at the time of exercise exceeds the \$3,000,000 exercise price.

NOTE 7 -- DISCONTINUED OPERATIONS - HOTELS

In December 2000, the Company discontinued its hotel segment, principally

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

by allowing its non-recourse debtholders to assume ownership of the properties through foreclosure or by selling or otherwise disposing of its hotel properties. The Company's former hotel segment consisted of three owned properties and two leased properties.

As of June 2002, the Company completed the disposition of all four hotel properties it had previously designated as discontinued operations. The Company determined that it would retain its leasehold interest in the GuestHouse Suites hotel in Huntsville, Alabama. The Company continues to operate the hotel, subject to a lease concession from the owner. Accordingly, this hotel has been classified as an asset held for use and operating results are reported within continuing operations.

Page 18

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS JUNE 30, 2003 (UNAUDITED)

A summary of the income from discontinued hotels operations for the three months and six months ended June 30, 2002 is detailed below (in thousands):

	THREE MONTHS ENDED JUNE 30, 2002	SIX MONTHS ENDED JUNE 30, 2002
	-----	-----
Revenue and Gain from Disposition		
Gain from extinguishment of debt	\$ 3,237	\$ 5,789
Sales	67	282
	-----	-----
	3,304	6,071
Expenses		
Deferred federal income tax expense	925	1,800
Operating expenses	66	323
Interest expense	46	183
Litigation and other disposition costs ..	9	31
	-----	-----
	1,046	2,337
	-----	-----
Income from discontinued hotel operations	\$ 2,258	\$ 3,734
	=====	=====

In January 2002, with assistance and consent of the mortgage lender, the Company sold the GuestHouse Suites hotel in Tulsa, Oklahoma for \$3,000,000. The Company received no cash proceeds from the sale; however, concurrently with the sale, it entered into a loan modification and assumption agreement, which included a release that discharged the Company from any further loan obligations. The Company recognized a gain from extinguishment of debt of \$2,552,000, before a deferred tax charge of \$875,000, in the 2002 first quarter.

In February 2002, the lender for the GuestHouse Suites hotel in Greenville, South Carolina obtained a court judgement of foreclosure. In connection with the foreclosure, the lender waived its right to a deficiency judgement against the Company and completed the foreclosure in June 2002. The Company recognized a gain from extinguishment of debt of \$3,237,000, before a

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

deferred tax charge of \$925,000, in the 2002 second quarter.

The Company was a defendant in two lawsuits regarding guaranties of certain obligations of the Embassy Suites and Holiday Inn hotels. In February 2003, the Company settled both matters. The Company agreed (i) to pay \$150,000 in cash and to issue a non-interest bearing promissory note in the amount of \$250,000, payable in equal monthly installments over 18 months, in exchange for a full release regarding the Embassy Suites hotel and (ii) to pay \$250,000 in cash in exchange for a full release regarding the Holiday Inn hotel. In December 2002, the Company recorded an additional loss provision in the amount of \$247,000 to fully accrue for these two litigation matters.

NOTE 8 -- DEFERRED REVENUE - NONCOMPETITION AGREEMENT

In March 2001, the Company agreed to sell its investment in Former HEC, which represented the Company's former energy operations, to Pure Resources II, Inc., an indirect wholly owned subsidiary of Pure Resources, Inc. ("Pure"). The Company received \$18,000,000 for its shares of common stock in May 2001 and received an additional amount of \$7,250,000, pursuant to the terms of a noncompetition agreement that was paid by Pure upon the completion of the merger in June 2001.

Under the noncompetition agreement, the Company agreed to refrain from taking certain actions without the prior written consent of Pure and Former HEC. These covenants were made by the Company in consideration of the transactions contemplated by the merger agreement and the payment by Pure to the Company. For a period of three years after the effective date of the merger agreement, the Company will not, directly or indirectly, engage in oil and gas activities in certain geographic areas without the prior consent of Pure. The Company also agreed to keep Former HEC's confidential and proprietary information strictly confidential.

The Company began amortizing the deferred revenue from the noncompetition agreement amount of \$7,250,000, over a three-year period commencing June 2001. The amortization was \$604,000 and \$1,208,000 in each of the three month and six month periods ended June 30, 2003 and 2002, respectively.

Page 19

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 JUNE 30, 2003
 (UNAUDITED)

NOTE 9 -- INCOME TAXES

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

	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,	
	2003	2002	2003	2002
Continuing Operations				
Federal expense (benefit)				
Deferred	\$ (3,147)	\$ 520	\$ (2,751)	\$ 1,086

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

Current	25	11	54	23
	-----	-----	-----	-----
Sub-total	(3,122)	531	(2,697)	1,109
State expense	236	85	399	245
	-----	-----	-----	-----
Total	\$ (2,886)	\$ 616	\$ (2,298)	\$ 1,354
	=====	=====	=====	=====
Discontinued Operations				
Federal expense				
Deferred	--	\$ 925	--	\$ 1,800
	=====	=====	=====	=====

The deferred tax asset (net of valuation allowance) was \$6,972,000 at June 30, 2003 and \$4,221,000 at December 31, 2002. The deferred tax asset arises principally from the anticipated utilization of the Company's net operating loss carryforwards ("NOLs") and tax credits from the implementation of various tax planning strategies, which include an anticipated gain from the potential sale of the HRP limited partner units and projected income from operations. As a result of the appreciation in market value of the HRP limited partner units as of June 30, 2003, management determined that the valuation allowance related to the deferred tax asset should be reduced to reflect the anticipated increase in utilization of NOLs. Accordingly, the Company recorded a deferred tax benefit of \$3,147,000 in the 2003 second quarter.

State tax expense is an estimate based upon taxable income allocated to those states in which the Company does business, at their respective tax rates.

Page 20

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2003
(UNAUDITED)

NOTE 10 -- SUPPLEMENTAL DISCLOSURES TO THE CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

DESCRIPTION	SIX MONTHS ENDED JUNE 30,	
	2003	2002
-----	-----	-----
Supplemental schedule of non-cash investing and financing activities:		
Additional investment in HRP pursuant to litigation settlement ..	\$ 2,988	--
Issuance of promissory note in litigation settlement	250	--
Hotel assets and liabilities relinquished in connection with debt extinguishment:		
Loan payable	--	\$ 11,609
Other liabilities, net	--	837
Hotel properties	--	(6,552)
Deferred tax asset	--	(1,800)

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

	-----	-----
	--	\$ 4,094
	=====	=====
Pro rata share of partners' capital transactions from equity investment in HRP:		
Amortization of interest rate swap	\$ (27)	\$ (29)
Exercise of stock options	(23)	--
Supplemental disclosures of cash payments:		
Interest paid	\$ 784	\$ 988
Income taxes paid (refunded)	711	(184)

Page 21

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2003
(UNAUDITED)

NOTE 11 -- COMPUTATION OF INCOME PER SHARE

The following table reconciles the Company's income from continuing operations to income from continuing operations available to common stockholders - assuming dilution, and the number of common shares used in the calculation for the basic and assuming dilution methods (in thousands):

DESCRIPTION	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,	
	2003	2002	2003	2002
-----	-----	-----	-----	-----
INCOME AVAILABLE TO COMMON STOCKHOLDERS				
Income from continuing operations	\$ 831	\$ 1,142	\$ 2,184	\$ 2,458
Less cash dividend on preferred stock	(50)	(50)	(50)	(50)
Interest expense (net of tax) of assumed loan conversion	--	--	--	28
	-----	-----	-----	-----
Income from continuing operations available to common stockholders - assuming dilution	\$ 781	\$ 1,092	\$ 2,134	\$ 2,436
	=====	=====	=====	=====
WEIGHTED AVERAGE SHARES OUTSTANDING				
Basic	1,361	1,361	1,361	1,361
Potential shares from assumed exercise of stock options	125	--	54	--
Potential repurchase of shares from stock option proceeds	(87)	--	(43)	--
Potential shares from assumed loan conversion ..	--	--	--	109
	-----	-----	-----	-----
Assuming dilution	1,399	1,361	1,372	1,470
	=====	=====	=====	=====

NOTE 12 -- LITIGATION, CONTINGENCIES AND COMMITMENTS

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

Reference is made to Note 18 to the consolidated financial statements contained in Form 10-K for the year ended December 31, 2002.

Litigation. In June 1997, an action was filed against the Company, HRP, the general partner Hallwood Realty Corporation, a predecessor entity to Hallwood Realty, and the directors of Hallwood Realty Corporation by Gotham Partners, L.P. in the Delaware Court of Chancery, styled Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., et al (C.A. No.15754). The action alleged claims of breach of fiduciary duties, breach of HRP's partnership agreement and fraud in connection with certain transactions involving HRP's limited partnership units in the mid 1990's. The Company was alleged to have aided and abetted the alleged breaches. In June 2000, after completing fact discovery, all parties moved for summary judgment on several issues. In September and October 2000, the Delaware court issued three separate written opinions resolving the summary judgment motions. In the opinions, the court ruled that trial would be required as to all issues, except that (i) Gotham was found to have standing to pursue its derivative claims; (ii) defendants were entitled to judgment dismissing the fraud claim; (iii) the general partner was entitled to judgment dismissing the breach of fiduciary duty claims brought against it; and (iv) the general partner's outside directors were entitled to judgment dismissing all claims brought against them. A five-day trial was held in January 2001. In July 2001, the Delaware Court of Chancery rendered its opinion. In its decision, the court determined that an option plan and a sale of units to the Company in connection with a reverse unit split implemented by HRP in 1995 were in compliance with HRP's partnership agreement. The court also found that the sale of units to the Company in connection with a 1995 odd-lot offer by HRP did not comply with certain procedures required by the HRP partnership agreement. The court ruled that the defendants other than HRP pay a judgment to HRP in the amount of \$3,417,000, plus pre-judgment interest of approximately \$2,891,000 from August 1995. The judgment amount represents what the court determined was an underpayment by the Company. In August 2001, the plaintiff and certain defendants appealed the Court of Chancery's judgment to the Delaware Supreme Court. In October 2001, the Company paid \$6,405,000, including post judgment interest, to HRP, subject to an arrangement that it be returned in full or part if the judgment was modified or reversed on appeal. Oral arguments before the Delaware Supreme Court were heard in February 2002, and a rehearing en banc was held in March

Page 22

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2003
(UNAUDITED)

2002. In August 2002, the Supreme Court affirmed the judgment of the trial court that the remaining defendants other than HRP are jointly and severally liable to HRP. The Supreme Court reversed the trial court's determination of damages, and remanded the case to the trial court to fashion appropriate relief. In July 2003, the Delaware Court of Chancery issued its decision after remand. In the decision, the Court of Chancery determined that defendants, including the Company, were required to pay to HRP the difference between the price paid for 293,539 units of HRP purchased by Hallwood in 1995 of \$14.20 per unit and the value of those units, including a control premium for those units, as determined by the court in its decision, of \$36.02 per unit, plus pre-judgment interest. The court also denied plaintiff's requests for rescission, rescissory damages or other forms of relief. In its earlier decision before remand, the trial court had determined that the value of the units was \$25.84 per unit and, as mentioned above, the Company is required to pay an additional amount of approximately

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

\$2,988,000 plus pre-judgment interest of approximately \$3,762,000. On July 25, 2003, the trial court entered its final order and judgment on remand which provided, among other things, that HRP pay plaintiffs \$3,000,000 in attorneys' fees, cost and expenses. On July 28, 2003, the plaintiff appealed the final order and judgment on remand to the Delaware Supreme Court. The \$6,750,000 judgment amount plus interest due is to bear interest at the statutory rate of 7% until paid.

As discussed in Note 4, the Company entered into an Amended and Restated Credit Agreement in July 2003, which provides a Special Purpose Credit Facility in the amount of \$5,000,000. Proceeds of the facility are to be used to pay a portion of the litigation judgment.

In April 2003, an action was filed against HRP's general partner, Hallwood Realty (the "General Partner"), its directors and HRP as nominal defendant by High River Limited Partnership ("High River"), which is indirectly wholly owned by Carl C. Icahn, in the Court of Chancery of the State of Delaware, styled High River Limited Partnership v. Hallwood Realty, LLC, et al, (C.A. No. 20276). The action challenges the unit purchase rights agreement dated November 30, 1990, between HRP and EquiServe Trust Company, N.A., as rights agent, as amended (the "Rights Plan"). High River claims in the suit that defendants have wrongfully utilized the Rights Plan to prevent High River and other third parties from purchasing 15% or more of the units of HRP, while at the same time exempting the General Partner and its affiliates and subsidiaries from the provisions of the Rights Plan. High River asserts that if defendants make additional purchases of units, they could render removal of the General Partner pursuant to the two-thirds removal provision of the partnership agreement impossible, thereby impeding or preventing the High River tender offer. The complaint, as amended, seeks as relief an order redeeming the rights, preventing defendants from treating the General Partner as exempt from or otherwise not subject to the definition of Acquiring Person under the Rights Agreement, or, alternatively, preventing defendants from treating High River as an Acquiring Person under the Rights Agreement or applying the Rights Agreement to the High River tender offer. The parties are proceeding with discovery. Trial is scheduled for September 2, 2003.

In April 2003, a putative class action lawsuit was filed against the General Partner, its directors and HRP as nominal defendant by three purported unitholders of HRP in the Court of Chancery of the State of Delaware, styled I.G. Holdings, Inc., et al, v. Hallwood Realty LLC, et al, (C.A. No. 20283). The action asserts that in allegedly refusing to consider the High River tender offer, the defendants are not acting in good faith and are deriving an improper personal benefit in impeding a potential removal of the General Partner or a sale of control of HRP, in breach of their fiduciary duties under the partnership agreement. The action further asserts that HRP's Schedule 14D-9 issued in response to the High River tender offer fails to disclose material information relating to the General Partner's recommendation regarding the offer. The complaint seeks as relief an order requiring the General Partner to consider the High River tender offer, an order preventing the General Partner or its affiliates from acquiring units or otherwise improperly entrenching the General Partner or impeding a transaction that would maximize value for the public unitholders, an order directing the defendants to use the Rights Plan fairly and disclose all material information in connection with the tender offer and the General Partner's recommendations and conclusions with respect thereto, and damages. This matter has been coordinated with the High River case and is therefore also scheduled for trial on September 2, 2003.

The Company was a party to certain litigation in the Delaware Court of Chancery styled, Corporate Property Associates 6 and Corporate Property Associates 7 v. The Hallwood Group Incorporated (C.A. 15661 - NC), that involves a four-year, \$500,000 promissory note of the Company due March 1998. The note was secured by a pledge of 89,269 HRP limited partner units. The agreement under

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

which the note was issued also provided that the pledgee ("CPA," or the "Noteholder") had the right to receive up to an additional \$500,000 based on the increase in price of the HRP units (the "HRP Participation Amount"). In 1996, the Company and CPA entered into an agreement under which the Company

Page 23

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2003
(UNAUDITED)

would pay off the principal and interest on the note and all other obligations between the parties would be ended. Subsequently, CPA refused to go forward with the agreement and this litigation was instituted. In December 1999, the Company and the Noteholder entered into an agreement, approved by the court, which provided that (i) the Company pay the face amount of \$500,000 plus \$83,000 of accrued interest to the Noteholder; (ii) the Company deposit \$900,000 into an escrow account to secure the maximum amount which could be payable by the Company, including a potential claim of \$400,000 for legal fees; and (iii) that the noteholder release its collateral of 89,269 HRP units. The parties reserved their rights to proceed with the litigation. Trial was held in June 2001 in the Delaware Court of Chancery. In February 2002, the court rendered its decision in favor of the Company. In March 2002, the court entered an order that provided for the return of approximately \$971,000, including accrued interest, to the Company from the escrow account. The Noteholder filed an appeal in April 2002. Oral arguments before the Delaware Supreme Court were heard in September 2002, and a rehearing en banc was held in November 2002. In March 2003, the Delaware Supreme Court issued its opinion reversing the finding of the Trial Court that certain language in the letter agreement in question constituted a general release of Hallwood's obligations. On March 21, 2003, the parties submitted to the Chancery Court an agreed proposed Order and Judgment, which was signed by the Court and terminated the litigation. The Order and Judgment provided for payment out of the escrowed funds of approximately \$547,000 to CPA and \$437,000 to the Company. The Company received its share of the escrowed funds on March 31, 2003.

The Company was a defendant in two lawsuits regarding guaranties of certain obligations of the Embassy Suites and Holiday Inn hotels. In February 2003, the Company settled both matters. The Company agreed (i) to pay \$150,000 in cash and to issue a non-interest bearing promissory note in the amount of \$250,000 payable in equal monthly installments over 18 months, in exchange for a full release regarding the Embassy Suites hotel, and (ii) \$250,000 in cash in exchange for a full release regarding the Holiday Inn hotel. In December 2002, the Company recorded an additional loss provision in the amount of \$247,000 to fully accrue for these two litigation matters.

The Company and its subsidiaries are from time to time involved in various other legal proceedings in the ordinary course of their respective businesses. Management believes that the resolution of the aforementioned litigation matters will not have a material adverse effect on the financial condition, results of operations or cash flows of the Company.

Contingencies. The Company has committed to make additional contributions to the capital of Hallwood Realty, upon demand, up to a maximum aggregate amount of \$13,118,000, subject to the terms of a subscription agreement, to the extent Hallwood Realty has insufficient capital to satisfy creditors of HRP. No such demands have been made.

In December 1999, the Company distributed certain assets and incurred a

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

contingent obligation, under the Separation Agreement. The contingent obligation, in the amount of \$4,000,000 at December 31, 2002, was the estimated value of the remaining payments under the Separation Agreement. In December 2001 the Company evaluated the contingent obligation and accrued an additional \$500,000 under this agreement, which was paid in 2002. Similarly, the Company reevaluated the obligation at December 2002, and determined that a further cost of \$1,000,000 should be accrued, which is expected to be paid in 2003 and 2004. The Company has an option to extinguish the future cash payments at any time prior to its expiration in December 2004 upon payment of \$3,000,000. See Note 6.

Further additional capital investments in HEC may be required. Depending upon the timing of the investments, an additional borrowing under the Company's revolving credit facility may be required.

In February 2000, Brookwood, through a wholly owned subsidiary, acquired the assets of a company in a textile products-related industry. The purchase price was \$1,479,000 in cash plus contingent payments of up to \$3,000,000, based on specified levels of earnings over the next four years. Effective December 31, 2001, in consideration of 36 monthly payments aggregating approximately \$375,000, the contingent obligation was reduced to a percentage of cash flow from the acquired subsidiaries, as defined, for the remaining years under the agreement. As of June 30, 2003, no amounts have been paid or were owed in relation to the contingency payments.

Page 24

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2003

(UNAUDITED)

NOTE 13 -- SEGMENT AND RELATED INFORMATION

The following represents the Company's reportable segment operations for the six months ended June 30, 2003 and 2002, respectively (in thousands):

	REAL ESTATE	TEXTILE PRODUCTS	OTHER	DISCONTINUED OPERATIONS	CONSOL -IDATED
	-----	-----	-----	-----	-----
SIX MONTHS ENDED JUNE 30, 2003					
Total revenue from external sources	\$ 2,051	\$ 49,065	\$ 2,021		\$ 53,137
	=====	=====	=====		=====
Operating income (loss)	\$ (2,425)	\$ 2,581			\$ 156
	=====	=====			=====
Unallocable (loss), net			\$ (270)		(270)
			=====		-----
Loss from continuing operations before income taxes					\$ (114)
					=====
SIX MONTHS ENDED JUNE 30, 2002					
Total revenue from external sources	\$ 3,429	\$ 44,475	\$ 2,337		\$ 50,241
	=====	=====	=====		=====
Operating income	\$ 2,526	\$ 1,283			\$ 3,809
	=====	=====			=====

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

Unallocable income, net	\$ 3	3
	=====	-----
Income from continuing operations before income taxes		\$ 3,812
		=====
Income from discontinued operations	\$ 3,734	\$ 3,734
	=====	=====

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, 2002 annual report. The total assets for the Company's operating segments have not materially changed since the December 31, 2002 annual report.

NOTE 14 -- CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE

SFAS No. 142 became effective January 1, 2002 and specifies that goodwill and some intangible assets will no longer be amortized but instead will be subject to periodic impairment testing. The effect of adopting SFAS No. 142 resulted in the recording of income from the cumulative effect of a change in accounting principle in the amount of \$568,000, which represented the unamortized amount of negative goodwill associated with the Company's equity investment in HRP.

NOTE 15 -- SUBSEQUENT EVENT

In August 2003, the Company completed the purchase of 35,000 of its common shares in a private transaction for approximately \$604,000. The shares will be recorded as treasury stock in the third quarter.

Page 25

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

RESULTS OF OPERATIONS

The Company reported net income of \$831,000 for the second quarter ended June 30, 2003, compared to \$3,400,000 in 2002. Net income for the six month periods was \$2,184,000 and \$6,760,000, respectively.

Income from continuing operations was \$831,000 for the second quarter of 2003, compared to \$1,142,000 in 2002. Revenue from continuing operations was \$25,782,000 in the second quarter of 2003, compared to \$25,887,000 in 2002. Income and revenue from continuing operations for the six months in 2003 were \$2,184,000 and \$53,137,000, compared to income and revenue of \$2,458,000 and \$50,241,000 in 2002, respectively.

Fee income from real estate operations has remained consistent in recent years, with an occasional spike in lease fees due to the execution of a large lease or development fee due to completion of a major project. Correspondingly, during the same period expenses have been fairly steady, except for the litigation expense in 2001 and 2003. Cash flow from operations, excluding the litigation expense, was \$3.8 million, \$4.5 million and \$4.7 million, respectively, for the three years ended December 31, 2002. Future cash flows are largely dependent on the leasing, development and management activities of the Company's subsidiaries on behalf of HRP. As discussed in Note 12, the Company continues to face litigation risk related to its real estate operations. An adverse ruling could impact the Company's general partner and limited partner

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

ownership interests and disrupt the Company's cash flow stream.

Textile products sales continues to experience severe competitive pressures from low-cost imports. This industry has been in decline in the United States; however, Brookwood continues to identify new market niches to replace sales lost to importers. In addition to its existing products and proprietary technologies, Brookwood has been developing advanced breathable, waterproof laminate materials, which have been well received by its 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 adapt to the global textile industry; however, there can be no assurance that the positive results of the past can be sustained.

The textile products business is not interdependent with any of the Company's other business operations. The Company does not guarantee the Brookwood bank debt and is not obligated to contribute additional capital. If the textile products business were to deteriorate, creditors could look only to Brookwood's assets for the satisfaction of its obligations.

The Company invested \$3,500,000 in HEC during 2002 and an additional \$1,051,000 (including \$139,000 in July 2003) in July 2003. HEC is presently in the development stage, having drilled and completed nine test wells in the Barnett Shale Formation of Johnson County, Texas. The Company owns 28% of HEC and accounts for the investment using the equity method of accounting. Certain of the Company's officers and directors are investors in HEC.

In December 2000, the Company discontinued its hotel segment, which at that time consisted of five hotel properties. Two hotels were disposed of in 2001, one hotel was sold in January 2002 and the lender completed a foreclosure on one hotel in May 2002. The Company continues to operate a leasehold interest in one hotel.

Following is an analysis of the results of continuing operations for the real estate, textile products and other business segments, as well as the discontinued operations for the hotel business segment.

REAL ESTATE

The real estate segment reported losses of \$3,564,000 for the second quarter of 2003 and \$2,425,000 for the six month period of 2003, compared to income of \$1,262,000 and \$2,526,000 in 2002, respectively.

Revenues. Fee income of \$1,151,000 for the 2003 second quarter decreased by \$212,000, or 16%, compared to \$1,363,000 in 2002. Fee income of \$2,398,000 for the 2003 six month period decreased by \$84,000, or 3%, compared to \$2,482,000 in 2002. Fees are derived from the Company's asset management, property management, leasing and construction supervision services provided to HRP and various third parties. The decreases were due primarily to lower leasing and construction supervision fees in the 2003 periods.

Page 26

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

Equity income (loss) from investments in HRP represents the Company's pro rata share of net income (loss) reported by HRP, adjusted for the elimination of intercompany profits. For the 2003 second quarter, the Company reported an

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

equity loss of \$663,000, compared to income of \$414,000 in 2002. For the 2003 six months, the equity loss was \$347,000, compared to income of \$947,000 in 2002. The decreases resulted principally from HRP's litigation costs and other costs associated with a tender offer for the HRP limited partner units by High River in 2003.

Expenses. Litigation expense of \$3,602,000 in the 2003 second quarter represents the interest component of the judgment in the Gotham Partners, L.P. v. Hallwood Realty Partners, L.P. et al matter discussed in Note 12, net of the Company's pro rata share of that amount which is expected to be recorded as income by HRP, and the Company's share of attorneys' fees payable by HRP to plaintiff's attorneys expected to be recorded as an expense by HRP.

Administrative expenses of \$282,000 decreased by \$65,000, or 19%, in the 2003 second quarter, compared to \$347,000 in 2002. For the six months, the decrease was \$29,000 to \$538,000, from \$567,000 in 2002. The decreases were primarily attributable to the payments of commissions associated with leasing income.

Amortization expense of \$168,000 for the second quarter and \$336,000 for the six months in both the 2003 and 2002 periods related to Hallwood Realty's general partner investment in HRP to the extent allocated to management rights, which is being amortized over a ten-year period ending in October 2003. At June 30, 2003, there was \$224,000 of unamortized investment remaining.

TEXTILE PRODUCTS

The textile products segment reported income of \$1,693,000 and \$2,581,000 for the second quarter and six month periods of 2003, compared to \$776,000 and \$1,283,000 in 2002, respectively.

Revenue. Sales of \$24,266,000 increased \$1,335,000, or 6%, in the 2003 second quarter, compared to \$22,931,000 in the 2002 second quarter. The comparative six months sales increased by \$5,313,000, or 12%, to \$49,065,000 from \$43,752,000 in the 2002 period. The increase was principally due to additional sales of specialty fabric to U.S. military contractors.

During 2000, Brookwood formed Strategic Technical Alliance ("STA"), a 50-50 joint venture, with an unrelated third party that is also in a textile-related industry. STA acquired the 50% ownership interest not owned by Brookwood in September 2002. Accordingly, STA became a wholly owned subsidiary in September 2002. Prior to the acquisition, Brookwood utilized the equity method of accounting for its investment in STA. Brookwood's equity income from STA was \$149,000 and \$723,000 in the 2002 second quarter and six month periods, respectively.

Expenses. Cost of sales of \$18,873,000 decreased by \$278,000, or 1%, in the 2003 second quarter, compared to \$19,151,000 in the 2002 second quarter. The decrease in cost of sales was principally the result of the sale of higher margin products. For the six months, the cost of sales increased by \$1,879,000, or 5%, to \$39,083,000 in 2003 from \$37,204,000 in 2002. The increase was attributable to the increased sales. The higher gross profit margin for the 2003 second quarter (22.2% versus 16.5%) and the six month periods (20.3% versus 15.0%) resulted from the sales increase of specialty fabric to military contractors.

Administrative and selling expenses of \$3,517,000 increased by \$572,000 in the 2003 second quarter, compared to \$2,945,000 for the 2002 period. For the six months, administrative and selling expenses increased \$1,455,000, or 26%, to \$7,069,000 from \$5,614,000 in 2002. The increases were primarily attributable to royalties incurred in 2003 to the Company's former joint venture partner in STA and payroll.

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

Interest expense of \$183,000 decreased by \$25,000, or 12%, for the 2003 second quarter, compared to \$208,000 in 2002. For the six months, interest expense of \$332,000 decreased by \$42,000, or 11%, from \$374,00 for the comparable 2002 period. The decreases were principally due to lower interest rates.

Page 27

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

OTHER

The other segment reported a loss of \$184,000 for the second quarter of 2003, compared to a loss of \$280,000 in 2002. For the six months, the other segment reported a loss of \$270,000, compared to income of \$3,000 in 2002.

Revenue. Amortization of deferred revenue was \$604,000 and \$1,208,000 in both the 2003 and 2002 second quarter and six month periods, respectively, and is attributable to the noncompetition fee received in connection with the sale of the Company's investment in Former HEC. The original \$7,250,000 cash payment is being amortized over a three year period which began June 2001.

Hotel revenue, which relates entirely to the leased Guest House Suites Plus hotel in Huntsville, Alabama, was \$367,000 in the 2003 second quarter and \$704,000 for the six months, compared to \$458,000 and \$898,000 in the comparable 2002 periods. The 22% decrease in 2003 was attributable to reduced occupancy, partially offset by an increased average daily rate. Revenues have been adversely impacted by a general downturn in the hotel industry and increased competition in the local market.

Equity income from investment in HEC in the amount of \$56,000 for the 2003 second quarter and \$107,000 for the six months relates to the Company's pro rata share of income from HEC's operations, compared to equity losses of \$36,000 and \$77,000, respectively, in the comparable 2002 periods.

Interest and other income decreased to \$1,000 for the 2003 second quarter, compared to \$4,000 in 2002. For the six months, interest and other income was \$2,000 in 2003, compared to \$308,000 in 2002. The decrease was principally attributable to a gain of \$296,000 from the exercise of an option and related sale of a marketable security in the 2002 first quarter.

Expenses. Administrative expenses of \$521,000 for the 2003 second quarter decreased by \$71,000, or 12%, from \$592,000 in 2002. For the six months, administrative expenses decreased by \$25,000 to \$949,000 from \$974,000 in 2002. The decreases are primarily due to reduced professional fees.

Interest expense in the amount of \$220,000 for the 2003 second quarter decreased by \$5,000 from \$225,000 in 2002. For the six months, interest expense decreased by \$7,000 to \$423,000 from \$430,000 in 2002. The decreases were primarily due to the repayment of the stockholder loan in 2002, partially offset by borrowings under the Term Loan and Revolving Credit Facility.

Hotel expenses, which include operating expenses, depreciation and interest costs were \$471,000 for the 2003 second quarter, which decreased by \$22,000, or 4%, compared to \$493,000 in 2002. For the six months, hotel expenses decreased by \$11,000 to \$919,000 from \$930,000 in 2002. The decreases were principally due to lower repairs and maintenance.

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

INCOME TAXES

Income taxes relating to continuing operations was a net benefit of \$2,886,000 for the 2003 second quarter, compared to an expense of \$616,000 in 2002. The 2003 quarter included a \$3,147,000 non cash federal deferred benefit, a \$25,000 federal current charge and \$236,000 for state taxes. The non-cash federal deferred benefit in 2003 is principally due a reduction in the valuation allowance related to the deferred tax asset, attributed to the increased value of the HRP limited partner units and the increase in anticipated gain from the potential sale of the units. The 2002 quarter included a \$520,000 non cash federal deferred charge, a \$11,000 federal current charge and \$85,000 for state taxes. Income taxes was a net benefit of \$2,298,000 for the 2003 six month period, compared to an expense of \$1,354,000 in 2002. The six months in 2003 included a deferred tax benefit of \$2,751,000, a \$54,000 federal current charge and \$399,000 for state taxes. The 2002 six month amount included a non-cash deferred tax charge of \$1,086,000, a federal current charge of \$23,000 and state tax expense of \$245,000. The state tax expense is an estimate based upon taxable income allocated to those states in which the Company does business at their respective tax rates.

As of June 30, 2003, the Company had approximately \$78,000,000 of tax net operating loss carryforwards ("NOLs") and temporary differences to reduce future federal income tax liability. Based upon the Company's expectations and

Page 28

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

available tax planning strategies, management has determined that taxable income will more likely than not be sufficient to utilize approximately \$20,500,000 of the NOLs prior to their ultimate expiration in the year 2020.

Management believes that the Company has certain tax planning strategies available, which include the potential sale of certain real estate investments, that could be implemented, if necessary, to supplement income from operations to fully realize the net recorded tax benefits before their expiration. Management has considered such strategies in reaching its conclusion that, more likely than not, taxable income will be sufficient to utilize a portion of the NOLs before expiration; however, future levels of operating income and taxable gains are dependent upon general economic conditions and other factors beyond the Company's control. Accordingly, no assurance can be given that sufficient taxable income will be generated for utilization of the NOLs. Management periodically re-evaluates its tax planning strategies based upon changes in facts and circumstances and, accordingly, considers potential adjustments to the valuation allowance of the deferred tax asset. Although the use of such carryforwards could, under certain circumstances, be limited, the Company is presently unaware of the occurrence of any event which would result in such limitations. In addition, utilization of NOLs in the future may be limited if changes in the Company's stock ownership create a change in control, as provided in Section 382 of the Internal Revenue Code of 1986, as amended.

DISCONTINUED OPERATIONS - HOTELS

In December 2000, the Company decided to discontinue its hotel operations and dispose of its hotel segment, principally by allowing its non-recourse debtholders to assume ownership of the properties through foreclosures or by selling or otherwise disposing of its hotel properties. The Company's former

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

hotel segment consisted of three owned properties and two leased properties. In accordance with accounting standards for reporting discontinued operations, hotel operations (apart from the leasehold interest in the GuestHouse Suites Plus hotel in Huntsville, Alabama that the Company continues to operate and has been classified as an asset held for use) have been segregated from the Company's continuing operations and have been reported as a single line item -- Loss from Discontinued Operations. Discontinued operations for the three month and six month periods ended June 30, 2002 are presented below (in thousands):

	THREE MONTHS ENDED JUNE 30, 2002	SIX MONTHS ENDED JUNE 30, 2002
	-----	-----
Revenue and Gain from Disposition		
Gain from extinguishment of debt	\$ 3,237	\$ 5,789
Sales	67	282
	-----	-----
	3,304	6,071
Expenses		
Deferred federal income tax expense	925	1,800
Operating expenses	66	323
Interest expense	46	183
Litigation and other disposition costs ..	9	31
	-----	-----
	1,046	2,337
	-----	-----
Income from discontinued hotel operations	\$ 2,258	\$ 3,734
	=====	=====

As of June 2002, the Company completed the disposition of all four hotel properties it had previously designated as discontinued operations.

Revenue. In January 2002, with assistance and consent of the mortgage lender, the Company sold the GuestHouse Suites hotel in Tulsa, Oklahoma for \$3,000,000. The Company received no cash proceeds from the sale; however, concurrently with the sale, it entered into a loan modification and assumption agreement which included a release that discharges the Company from any further loan obligations. The Company recognized a gain from extinguishment of debt of \$2,552,000, before a deferred tax charge of \$875,000, in the 2002 first quarter.

Sales of \$67,000 in the 2002 second quarter and \$282,000 in the six month period were principally attributable to the GuestHouse Suites hotel in Greenville, South Carolina, prior to its disposition in June 2002.

Page 29

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

Expenses. Operating expenses of \$66,000 in the 2002 second quarter and \$323,000 for the six months and interest expense of \$46,000 for the 2002 second quarter and \$183,000 for the six months related to the Greenville hotel prior to its disposition. The litigation and other disposition costs principally relate to legal fees and other expenses in connection with the disposition and resolution of two litigation matters discussed below.

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

The Company was a defendant in two lawsuits regarding guaranties of certain obligations of the Embassy Suites and Holiday Inn hotels. In February 2003, the Company settled both matters. The Company agreed (i) to pay \$150,000 in cash and to issue a non-interest bearing promissory note in the amount of \$250,000 payable in equal monthly installments over eighteen months, in exchange for a full release regarding the Embassy Suites hotel and (ii) to pay \$250,000 in cash in exchange for a full release regarding the Holiday Inn hotel. In December 2002, the Company recorded an additional loss provision in the amount of \$247,000 to fully accrue for these two litigation matters.

CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE

SFAS No. 142 became effective January 1, 2002 and specifies that goodwill and some intangible assets will no longer be amortized but instead will be subject to periodic impairment testing. The effect of adopting SFAS No. 142 by the Company resulted in the recording of income from the cumulative effect of a change in accounting principle in the amount of \$568,000, which represented the unamortized amount of negative goodwill associated with the Company's equity investment in HRP.

INVESTMENT IN HALLWOOD ENERGY CORPORATION

The Company owns approximately 28% of HEC. It accounts for the investment using the equity method of accounting and records its pro rata share of HEC's net income (loss), stockholders' equity transactions and comprehensive income (loss) adjustments, if any.

The Company invested \$3,500,000 in HEC during 2002 and an additional \$1,051,000 in 2003 (including \$139,000 in July 2003). HEC is presently in the development stage, having drilled nine test wells in the Barnett Shale formation of Johnson County, Texas. After constructing a gas gathering system, HEC commenced commercial production and sales from three of the nine wells in February 2003. Currently, eight wells are producing and one well has been temporarily abandoned. Aggregate production, including royalty owner share and minor working interest participation, rose to 3.0 million cubic feet of gas per day during the first week of May 2003, and was approximately 2.6 million cubic feet of gas per day at August 8, 2003. The reduction in production is due in part to the natural decline experienced in Barnett Shale wells, coupled with a temporary slow down in drilling activity between May and July 2003.

In addition to the above, HEC has drilled the Worthington #1 which will serve as a Texas Railroad Commission Class 1 disposal well and will be used to accommodate disposed water for HEC as well as third parties. Additional operations in progress at July 31, 2003 include the drilling of two additional Barnett Shale wells. HEC anticipates completion operations to commence on these properties by the middle of August 2003.

HEC currently plans to drill between 10 and 20 wells during the balance of 2003; however, this number may vary based upon a variety of operational and economic conditions. Whether HEC drills 10 or 20 additional wells this year, additional capital will be required. HEC currently anticipates that it will solicit equity contributions from its shareholders in combination with secured borrowings to meet its capital requirements. Depending on the level of borrowings, coupled with the ultimate level of well development activity, HEC may request from its shareholders additional equity contributions over the next six to eight months of approximately \$5,000,000. Based on the Company's current ownership percentage, if approved by the Company's board of directors, its equity contribution may total approximately \$1,400,000.

HEC holds oil and gas leases covering approximately 34,500 gross and 30,300 net acres of undeveloped leasehold, predominantly in Johnson County,

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

Texas as of July 31, 2003.

CRITICAL ACCOUNTING POLICIES

There have been no changes to critical accounting policies identified and set forth in the Company's Annual Report on Form 10-K for the year ended December 31, 2002.

Page 30

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

RELATED PARTY TRANSACTIONS

HRP. The Company's real estate subsidiaries earn asset management, property management leasing and construction supervision fees for their management of HRP's real estate properties. Hallwood Realty earns: (i) an asset management fee equal to 1% of the net aggregate base rents of HRP's properties, (ii) acquisition fees equal to 1% of the purchase price of newly acquired properties and; (iii) disposition fees with respect to real estate investments, other than the properties owned at the time of HRP's formation in 1990, equal to 10% of the amount by which the sales price of a property exceeds the purchase price of such property. HCRE earns property management, leasing and construction supervision fees. The management contracts with HRP expire on June 30, 2004 and provide for: (i) a property management fee equal to 2.85% of cash receipts collected from tenants; (ii) leasing fees equal to the current commission market rate as applied to net aggregate rent (none exceeding 6% of the net aggregate rent); and (iii) construction supervision fees for administering construction projects equal to 5% of total construction or tenant improvement costs.

A summary of the fees earned from HRP is detailed below (in thousands):

	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,	
	2003	2002	2003	2002
Property management fees	\$ 512	\$ 520	\$ 998	\$ 994
Leasing fees	305	464	690	690
Asset management fees	151	154	303	309
Construction supervision fees	113	128	297	385
	-----	-----	-----	-----
Total	\$ 1,081	\$ 1,266	\$2,288	\$2,378
	=====	=====	=====	=====

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

HSC Financial Corporation. The Company has entered into a financial

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

consulting contract with HSC Financial Corporation ("HSC"), a corporation associated with Mr. Anthony J. Gumbiner, the Company's chairman and principal stockholder. The contract provides for HSC to furnish and perform international consulting and advisory services to the Company and its subsidiaries, including strategic planning and merger activities, at a rate of \$795,000 per year. HSC is also eligible for bonuses from the Company or its subsidiaries, subject to approval by the Company's or its subsidiaries' board of directors. Additionally, the Company reimburses HSC for reasonable and necessary expenses of office space and administrative services. A summary of the fees and expenses paid to HSC are detailed below (in thousands):

	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,	
	2003	2002	2003	2002
Consulting fees	\$ 199	\$ 199	\$ 398	\$ 398
Office space and administrative services	25	22	50	41
	-----	-----	-----	-----
Total	\$ 224	\$ 221	\$ 448	\$ 439

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

HEC. The Company invested \$3,500,000 in HEC during 2002 and an additional \$1,051,000 in 2003 (including \$139,000 in July 2003). HEC is a private energy company. The Company owns approximately 28% of HEC and

Page 31

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

accounts for the investment using the equity method of accounting. Certain of the Company's officers and directors are investors in HEC.

Brookwood. During 2000, Brookwood formed STA with an unrelated third party that is also in a textile-related industry, principally to produce advanced, breathable, waterproof laminate materials for military applications. In September 2002, STA acquired the 50% ownership interest not owned by Brookwood for \$1,000,000 in cash, the issuance of a \$596,000 note bearing interest at the prime rate and royalty payments for three years based upon production under a specified contract. Accordingly, STA became a wholly owned subsidiary of Brookwood in September 2002. Brookwood reported sales to STA of \$4,516,000 and \$8,981,000 for the three month and six month periods ended June 30, 2002, respectively.

CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS

Edgar Filing: HALLWOOD GROUP INC - Form 10-Q

The Company and its subsidiaries have entered into various contractual obligations and commercial commitments in the ordinary course of conducting its business operations, which are provided below as of June 30, 2003 (in thousands):

	PAYMENTS DUE DURING THE YEAR ENDING DECEMBER 31,					
	2003*	2004	2005	2006	2007	THEREAFTER
CONTRACTUAL OBLIGATIONS						
Long term debt						
Term Loan and Revolving						
Credit Facility	\$ 499	\$ 1,052	\$ 2,585	\$ --	\$ --	\$ --
Loan Payable	83	153	--	--	--	--
10% Debentures (face amount)	--	--	6,468	--	--	--
Loans payable (Brookwood) ..	430	14,238	413	209	125	21
Capital lease obligations	264	544	--	--	--	--
Separation Agreement	250	3,500	--	--	--	--
Op						