HALLWOOD GROUP INC
Form 10-K
March 30, 2004

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

Mark One	
þ	**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the transition period from to**

For the Year Ended December 31, 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 þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in, definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes o No þ

The aggregate market value of the Common Stock, $0.10 par value per share, held by non-affiliates of the registrant as of June 30, 2003, based on the closing price of $14.60 per share on the American Stock Exchange, was $8,698,000.

1,326,343 shares of Common Stock, $0.10 par value per share, were outstanding at March 26, 2004.

DOCUMENTS INCORPORATED BY REFERENCE

The information called for by Part III is incorporated by reference to the definitive Proxy Statement for the Annual Meeting of Stockholders of the Company to be filed with the Securities and Exchange Commission not later than 120 days after December 31, 2003.

THE HALLWOOD GROUP INCORPORATED

FORM 10-K

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PART I

Item 1. ***Business***

The Hallwood Group Incorporated (Hallwood or the Company) (AMEX:HWG), a Delaware corporation, is a holding company that classifies its primary continuing business operations into two segments; real estate and textile products. Financial information for each business segment is set forth in Note 19 to the consolidated financial statements. The Company s former energy and hotel business segments were previously reclassified as discontinued operations.

Real Estate. Real estate operations are conducted primarily through the Company s wholly owned subsidiaries, HWG, LLC, Hallwood Realty, LLC (Hallwood Realty) and Hallwood Commercial Real Estate, LLC (HCRE). Hallwood Realty is the sole general partner of Hallwood Realty Partners, L.P. (HRP), a publicly-traded, master limited partnership (AMEX:HRY). At December 31, 2003, HRP owned 14 real estate properties in six states containing 5,207,000 net rentable square feet. HRP seeks to maximize the value of its real estate by making capital and tenant improvements, by executing marketing programs to attract and retain tenants, and by controlling or reducing, where possible, operating expenses. HRP s Form 10-K for the year ended December 31, 2003 is included elsewhere within this document.

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

Tender Offer. On May 1, 2003, High River Limited Partnership (High River), 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, the board of directors of Hallwood Realty evaluated the offer and advised HRP 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 had engaged Morgan Stanley & Co. Incorporated to initiate discussions with parties interested in participating in a transaction with HRP and stating that, if Mr. Icahn were interested in participating in that process, he should contact Morgan Stanley. On August 19, 2003, High River announced an increase in the purchase price in its tender offer to $120 per unit, subject to a variety of conditions, including High River achieving ownership of 66 2/3% of the outstanding HRP units. Thereafter, the board of directors of Hallwood Realty evaluated the revised offer and advised unitholders to reject the offer as inadequate. Prior to the tender offer, High River owned 235,000 units and as of March 22, 2004, 65,708 units had been tendered to High River. The offer has been extended several times and currently expires April 2, 2004.

At the direction of the board of directors of Hallwood Realty, Morgan Stanley is actively engaged in a process of identifying alternatives that may be in the best interests of the HRP unitholders, focusing primarily on 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 of HRP, including 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 or any of its subsidiaries. Although HRP is working with Morgan Stanley and these interested parties, there can be no assurance that a transaction with respect to HRP will result from those discussions.

Real estate accounted for 4% of the Company s total revenues from continuing operations in 2003, compared to 7% in 2002 and 10% in 2001.

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

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

The Brookwood Roll Goods Division serves manufacturers by maintaining an extensive in-stock, short-lot service of woven nylon and polyester fabrics, offering an expansive inventory in excess of two million yards stocked in a wide array of colors. As speed is essential in this area, Brookwood Roll Goods has positioned its sales and distribution facilities in southern California and Rhode Island to allow shipment on a same day/ next day basis.

The First Performance Fabric Division buys and sells promotional goods, remnants and mill seconds for a vast assortment of coated and uncoated nylon products at promotional prices. Products include nylon for consumer uses, such as activewear, outerwear, swimwear as well as nylons used for balloons, luggage, bags, flags and banners.

During 2000, Brookwood formed a joint venture, Strategic Technical Alliance, LLC (STA), with an unrelated party that is also in a textile-related industry. The business of STA is to market advanced breathable, waterproof laminate materials for military applications. STA was 50% owned by each party with operating and management decision-making shared equally by both parties. In September 2002, STA acquired the 50% ownership interest not owned by Brookwood, effectively making STA a wholly owned Brookwood subsidiary. Since that date, the financial results of STA have been fully consolidated. Prior to the acquisition, Brookwood used the equity method of accounting.

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

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

Textile products accounted for 92% of the Company s total revenues from continuing operations in 2003, compared to 88% in 2002 and 86% in 2001.

Other. Other revenues include amortization of deferred revenue from a $7,250,000 noncompetition fee received from the sale of its former energy investment in May 2001, revenue from a leased hotel property (a 112-room GuestHouse Suites Plus hotel in Huntsville, Alabama), equity income (loss) from its investment in an affiliated, private energy company and interest and other income.

Other expenses include administrative, interest, hotel operating costs, cost of a separation agreement among the Company, a former officer and director and a related trust (the Separation Agreement), and loss from debt extinguishment. Administrative expenses represent the general costs of operating a public company, including consulting fees paid to HSC Financial Corporation, an entity associated with the Company s chairman and principal stockholder, Anthony J. Gumbiner. Hotel operating costs relate only to the leased hotel property the Company continues to operate. Interest expense relates principally to loans with First Bank & Trust N.A. under an amended and restated credit agreement (the Amended and Restated Credit Agreement) and predecessor term loan and revolving credit facility (the Term Loan and Revolving Credit Facility), 10% Collateralized Subordinated Debentures (the 10% Debentures), the cost of Separation Agreement, the former Senior Secured Term Loan and former loans from the Company s chairman and principal stockholder. The cost of Separation Agreement recorded in 2002 represents an additional accrual for the sum of future cash payments through December 2004. The loss from extinguishment of debt relates to the write off of unamortized deferred loan costs associated with the repayment of the former Senior Secured Term Loan in 2001.

Energy Investments. The Company invested $3,500,000 in Hallwood Energy Corporation (HEC), an affiliated, private energy company during 2002, $1,997,000 in 2003, and an additional $566,000 in January 2004. As of March 23, 2004, HEC has drilled or is in the process of drilling 37 wells in the Barnett Shale Formation of Johnson County, Texas. After constructing a gas gathering system, HEC commenced commercial production and sales of natural gas in February 2003. Twenty-six wells are producing, one well has been plugged and abandoned, one well is being drilled and eight wells are in various stages of completion and/or connection to the gathering system. Additionally, HEC has completed a commercial salt water disposal well and facility, which went into operation in March 2004 and will serve HEC s disposal needs as well as accommodate disposed water of third parties.

Aggregate natural gas production in March 2004, including royalty owner share and minor working interest participation, rose to over 18 million cubic feet per day and HEC is transporting third party gas of approximately three million cubic feet per day. Additional production is presently curtailed due to restrictions at the TXU Energy (TXU) metering and sales tap in Cleburne. HEC and TXU are in the process of expanding this facility, which will allow HEC to deliver in excess of 21 million cubic feet of gas per day. These facility modifications are in process and will be completed in the 2004 second quarter. HEC believes that existing wells, new wells drilled and wells in the completion stage will bring combined total sales to a level in excess of the increased capacity at the Cleburne facility in the near future and HEC is constructing an additional tap and compression facility to the TXU sales line. Additionally, HEC is in the process of securing a tap and facility that will allow take away south of the Cleburne facility and into a separate transmission line.

HEC could drill in excess of 50 wells in 2004; however, drilling plans may vary depending upon a number of variables and economic conditions. HEC secured a $15,000,000 loan facility in December 2003 and as of March 1, 2004 had drawn $10,000,000 on the facility. HEC is attempting to secure a revolving line of credit from a commercial oil and gas lending bank to fund additional capital requirements in 2004 and to eliminate the existing loan.

HEC holds oil and gas leases covering approximately 38,000 gross and 34,000 net acres in Johnson and Hill Counties, Texas as of March 1, 2004.

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.

In the 2004 first quarter, the Company invested $659,000 in Hallwood Exploration, L.P. (Hallwood Exploration), a newly formed, affiliated, private energy company. Hallwood Exploration was formed to develop an oil and gas exploration opportunity in Louisiana and is currently acquiring leases and seismic data. The Company owns approximately 20% of Hallwood Exploration and will account for the investment using the equity method of accounting. Certain of the Company s officers and directors are investors in Hallwood Exploration.

Discontinued Operations Hotels. Hotel operations were conducted through the Company s wholly owned subsidiaries, Hallwood Hotels, Inc. (Hallwood Hotels) and Brock Suite Hotels, Inc. (Brock Hotels). Hallwood Hotels held a long-term leasehold interest in the Holiday Inn and Suites hotel, located in Longboat Key, Florida and a fee interest in the Airport Embassy Suites hotel, located in Oklahoma City, Oklahoma. Brock Hotels owned fee interests in two GuestHouse Suites Plus properties located in Tulsa, Oklahoma and Greenville, South Carolina, and holds a long-term leasehold interest in a GuestHouse Suites Plus property located in Huntsville, Alabama.

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In December 2000, the Company decided to dispose of its hotel segment, principally by allowing its non-recourse debt holders to assume ownership of the properties through foreclosures, or by selling or otherwise disposing of its hotel properties, and recorded impairments to reduce the carrying value of the hotels to estimated market value. In December 2001, the Company further evaluated each of the hotels operated and determined it was appropriate to record additional impairments of $935,000 to reduce their carrying values to estimated fair market values.

In January 2001, a receiver was appointed to administer the disposition of the GuestHouse Suites Plus hotel in Greenville, South Carolina. In February 2001, the Company signed an Agreement to Terminate Lease with the landlord of the Holiday Inn and Suites hotel in Sarasota, Florida. In March 2001, receivers were appointed to administer the disposition of the GuestHouse Suites Plus hotel in Tulsa, Oklahoma and the Airport Embassy Suites hotel in Oklahoma City, Oklahoma. In June 2001, the Company entered into a settlement agreement with the mezzanine lender whereby the Company transferred all of its capital stock of Hallwood Hotels OKC, Inc., the entity that owned the Embassy Suites hotel, to the mezzanine lender and obtained a release from its obligations under the first mortgage and the mezzanine loan. The Company reported the transaction as a gain from extinguishment of debt in the amount of $316,000, before a deferred tax charge of $100,000.

During 2001, the Company determined it would retain its leasehold interest in the GuestHouse Suites Plus hotel located in Huntsville, Alabama, the results of which have been reported in continuing operations.

In January 2002, with assistance and consent of the lender, the Company sold the GuestHouse Suites Plus 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 February 2002, the lender for the GuestHouse Suites Plus hotel in Greenville, South Carolina obtained a court judgment of foreclosure. In connection with the foreclosure, the lender waived its right to a deficiency judgment against the Company. The lender completed the foreclosure in June 2002 and the Company recognized a gain from extinguishment of debt of $3,237,000, before a deferred tax charge of $925,000.

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. The Company has made all scheduled payments in accordance with the settlement agreements and the aforementioned promissory note will be fully amortized in December 2004.

Discontinued Operations Energy. In March 2001, Hallwood Energy Corporation (Former Hallwood Energy) announced that it had signed a definitive merger agreement pursuant to which Pure Resources II, Inc., an indirect wholly owned subsidiary of Pure Resources, Inc. (Pure), agreed to acquire all the outstanding common stock and Series A Cumulative Preferred Stock of Former Hallwood Energy. In May 2001, Pure announced that it had successfully completed its tender offer. The Company received $18,000,000 for the tender of its 1,440,000 shares of common stock in May 2001 and received an additional $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 (described below) without the prior written consent of Pure and Former Hallwood Energy. 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 may not, directly or indirectly, engage in certain oil and gas activities in certain geographic areas without the prior consent of Pure. Former Hallwood Energy was engaged in the development, exploration, acquisition and production of oil and gas properties. Former Hallwood Energy owned interests in properties primarily located in the San Juan Basin in New Mexico and Colorado, South Texas, the Permian Basin in West Texas and onshore

South Louisiana. The Company also agreed to keep Former Hallwood Energy s confidential and proprietary information strictly confidential.

Competition, Risks and Other Factors

The Company.

If the Company cannot generate sufficient cash flows from operations, it may need additional capital. If the Company cannot generate enough cash flow from operations to finance its business in the future, it will need to raise additional capital through public or private financing or asset sales. If the Company borrows money, it may be required to agree to restrictions limiting its operating flexibility. If the Company requires additional capital but is not able to obtain such capital, it would have a material adverse effect on its operations and the Company s ability to service its existing debt.

Risk of Rising Interest Rates. A portion of the Company s indebtedness bears interest at variable rates. In addition, the Company may incur indebtedness in the future that also bears interest at a variable rate or may be required to refinance its debt at higher rates. Accordingly, increases in interest rates could increase the Company s interest expense, which could adversely affect cash flow from future operations and the Company s ability to service its debt.

Influence of Significant Stockholder. The Company s chairman, Anthony J. Gumbiner, is a significant stockholder of the Company. Mr. Gumbiner owns approximately 64% of the Company s outstanding common stock (68% including currently exercisable stock options) as of March 2004. Accordingly, Mr. Gumbiner can exert substantial influence over the affairs of the Company.

Competition for Skilled Personnel Could Increase Labor Costs. The Company competes with various other companies in attracting and retaining qualified and skilled personnel. It depends on its ability to attract and retain skilled management personnel who are responsible for the day-to-day operations of the Company. Competitive pressures may require that the Company enhance its pay and benefits package to compete effectively for such personnel. If there is an increase in these costs, or if the Company fails to attract and retain qualified and skilled personnel, its business and operating results could be adversely affected.

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

Restrictions on Stock Transfers and Ownership Limits. The Company s Second Restated Certificate of Incorporation contains a provision that restricts transfers of the Company s common stock in order to protect certain federal income tax benefits. The restriction prohibits any transfer of common stock to any person that results in ownership in excess of 4.75% of the then outstanding shares. The restriction can be waived only with the approval of the Company s board of directors. The restriction can impede a third party from acquiring the Company, even if such an acquisition would be beneficial to the Company s stockholders.

Risk of Loan Covenant Violations or 10% Debenture Restrictions. The Company s Amended and Restated Credit Agreement and 10% Debentures require compliance with various loan covenants and financial ratios, which, if not met, will trigger a default. The Amended and Restated Credit Agreement requires a minimum net cash flow, as defined, of $4,400,000, a minimum debt service coverage ratio for each rolling four quarter period, as defined, of 1.20 to 1.00, a senior leverage ratio, as defined, of no greater than 2.50 to 1.00 and a minimum collateral value coverage of 200% of the outstanding loan balance. Additionally, Brookwood s credit agreement requires compliance with various loan covenants and financial ratios, principally a current ratio of 1.40 to 1.00, an EBITDA to total fixed charges ratio of 1.25 to 1.00 and a total funded debt to total capitalization ratio of 45%. The Indenture governing the 10% Debentures contains various covenants, principally associated with a subsidiary commencing receivership, bankruptcy or insolvency proceedings, which if violated, may result in a call of the entire issue.

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Risk of Litigation. The Company is currently a party to various litigation matters, as described more fully in Item 3 Legal Proceedings and Note 18 to the Company s consolidated financial statements. An unfavorable decision on the matters could have an adverse effect on the Company. In particular, the Company is a defendant in certain litigation in Delaware state court styled *High River Limited Partnership/ I.G. Holdings, Inc. vs. Hallwood Realty LLC, et al.*

Real Estate.

Concentration Risks. The Company s real estate subsidiaries receive a substantial portion of their revenues from management, leasing and other services provided to HRP. Any adverse effect on HRP s operations could affect the Company through reduced fee income. Further, the early cancellation or non-renewal of the management contracts between HRP and the Company s real estate subsidiaries, which currently provide that they expire in June 2004, would have a material adverse effect on the Company.

Deterioration in Economic Conditions and the Real Estate Markets Could Impair HRP s Business. The commercial real estate industry depends on a number of factors relating to global, national, regional and local general and economic conditions, including war, threat of war, inflation, interest rates, taxation policies, availability of credit, employment levels, and wage and salary levels. A negative trend in any of these conditions could adversely affect HRP s business. If a substantial number of tenants default on their leases, choose not to renew, or if rental rates decrease, HRP s financial position could be adversely affected. Such effects could include a decline in acquisition, disposition and leasing activity; a decline in the supply of capital invested in commercial real estate; or a decline in the value of real estate.

HRP s cash flow would be adversely affected by decreases in the performance of the properties it owns. Property performance typically depends upon the ability to attract and retain creditworthy tenants; the ability to manage operating expenses; the magnitude of defaults by tenants under their respective leases; governmental regulations; the nature and extent of competitive properties; financial and economic conditions generally and in the specific areas where properties are located; and the real estate market generally. Expenses may increase due to unexpected or higher repairs and maintenance costs, inflation, services and costs required to retain tenants or to sign new tenants, unsuccessful appeals of rising real estate taxes, changes in interest rates, higher insurance costs, the outcome of existing or future litigation, as well as other factors, many of which are beyond the control of HRP.

Interest Rate Risks. Because only one of its mortgage loans, with a $25,000,000 principal balance and interest at LIBOR plus 130 basis points, has a floating interest rate, HRP s exposure to changes in market interest rates is limited to the difference between the market rate in effect at the time a loan matures compared to its existing interest rate. As of December 31, 2003, HRP had mortgage loans totaling $184,554,000 with fixed interest rates from 5.76% to 8.7% (with an effective average interest rate of 8.0%). These loans mature between 2005 and 2020. At the time of loan maturity, a higher market interest rate, compared to the existing rate, will have a negative impact on the amount of mortgage proceeds secured from a refinancing, as well as a decrease in cash flow from future operations due to the higher interest rate.

Insurance Risks. Due in large part to the terrorist activities of September 11, 2001, insurance companies have re-examined many aspects of their business, and have taken certain actions in the wake of these terrorist activities, including increasing premiums, mandating higher self-insured retentions and deductibles, reducing limits, restricting coverages, imposing exclusions (such as sabotage and terrorism), and refusing to underwrite certain risks and classes of business. Significantly increased premiums, mandated exclusions, or changes in limits, coverages, terms and conditions could adversely affect HRP s ability to obtain appropriate insurance coverages. However, at this time the only impact on HRP has been an increase in premiums. HRP has terrorism insurance coverage of $100,000,000 for liability and for full value of its properties.

Environmental Risks. Various national, state and local laws and regulations impose liability on real property owners, such as HRP, for the cost of investigating, cleaning up or removing contamination caused by hazardous or toxic substances. The liability may be imposed even if the original actions were legal and HRP did not know of, or was not responsible for, the presence of such hazardous or toxic substances. HRP may also be solely responsible for the entire payment of the liability if it is subject to joint and several liability with other

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responsible parties who are unable to pay. HRP may be subject to additional liability if it fails to disclose environmental issues to a buyer or lessee of property or if a third party is damaged or injured as a result of environmental contamination emanating from the site. HRP cannot be sure that any of such liabilities to which it may become subject will not have a material adverse effect upon its business, results of operations or financial condition. Certain HRP properties are known to contain asbestos. Removal of asbestos at HRP s properties is not required because it is cementitious, it is not friable and because the procedures in HRP s site environmental program Operations and Maintenance Manual are performed as required.

Competition. HRP s properties are subject to substantial competition from similar properties in the vicinity in which they are located. In addition, there are numerous other potential investors seeking to purchase improved real property and many property holders seeking to dispose of real estate with which HRP will compete, including companies substantially larger than HRP and with substantially greater resources.

Other. HRP s business is subject to other factors: (i) HRP s basic investment strategy is to hold real estate properties until what it believes to be an optimal time to sell them. HRP normally would sell properties during relatively strong real estate markets, however factors beyond HRP s control could make it necessary for HRP to dispose of properties during weak markets. Further, markets for real estate assets are not usually highly liquid, which can make it particularly difficult to realize acceptable prices when disposing of assets during weak markets; (ii) HRP has financed its operations with cash flow from profitably operating its established properties. If HRP does not generate enough cash from operations to finance its business in the future, it will need to raise additional funds through public or private financing or asset sales. If HRP borrows additional funds, it may be required to agree to restrictions limiting its operating flexibility. If HRP requires additional funds and is not able to obtain such funds, it would have a material adverse effect on HRP s operations; (iii) HRP has certain mortgage loans that require compliance with loan covenants and restrictions, which if not met will trigger a default. Additionally, these loans contain restrictions that limit certain actions; and (iv) HRP is currently a party to certain litigation, the outcome of which is uncertain.

Textile Products.

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

Concentration of Revenue Risk. Brookwood had one customer that accounted for more than 10% of its net sales during 2003 and 2002. The relationship with the customer is ongoing and Brookwood expects to maintain comparable sales volumes with that customer in 2004. Sales to that customer were $30,067,000, $18,600,000 and $3,800,000 in 2003, 2002 and 2001, respectively.

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

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

Risk of Loan Covenant Violations. Brookwood s credit agreement requires compliance with various loan covenants and financial ratios, principally a current ratio of 1.40 to 1.00, an EBITDA to total fixed charges ratio

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of 1.25 to 1.00 and a total funded debt to total capitalization ratio of 45%. Brookwood was in compliance with its loan covenants for all interim periods during 2003 and as of December 31, 2003.

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

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

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

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

Competition. The cyclical nature of the textile and apparel industries, characterized by rapid shifts in fashion, consumer demand and competitive pressures, results in both price and demand volatility. The demand for any particular product varies from time to time based largely upon changes in consumer preferences and general economic conditions affecting the textile and apparel industries, such as consumer expenditures for non-durable goods. The textile and apparel industries are also cyclical because the supply of particular products changes as competitors enter or leave the market.

Brookwood sells primarily to domestic manufacturers, some of which operate offshore sewing operations. Some of Brookwood s customers have moved their business offshore during the past few years. Brookwood has responded by shipping fabric to Asia directly and also by supplying finished products and garments directly to manufacturers. Brookwood competes with numerous domestic and foreign fabric manufacturers, including

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companies larger in size and having greater financial resources than Brookwood. The principal competitive factors in the woven fabrics markets are price, service, delivery time, quality and flexibility, with the relative importance of each factor depending upon the needs of particular customers and the specific product offering. Brookwood s management believes that Brookwood maintains its ability to compete effectively by providing its customers with a broad array of high-quality fabrics at competitive prices on a timely basis.

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

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

The U.S. textile industry has been and continues to be negatively impacted by existing worldwide trade practices. The establishment of the World Trade Organization (WTO) in 1995 has resulted in the phase out of quotas on textiles and apparel through 2004. In addition, tariffs on textile and apparel products will be reduced, but not eliminated, over the same ten-year period. After the end of ten years, the textile and apparel trade would revert to regular WTO rules that prohibit quotas and most other non-tariff barriers. The U.S. government has recently unveiled a proposal to eliminate worldwide tariffs for manufactured goods by 2015. The European Union has also proposed significant reductions in tariffs. These proposals will be discussed during the ongoing WTO Doha Round of multilateral negotiations, and could lead to further significant changes in worldwide tariffs beyond those already anticipated.

The U.S. government has also engaged in discussions with a number of countries or trading blocs with the intent of further liberalizing trade; fast track authority to negotiate new agreements has been granted by Congress, making new agreements in this field more likely. China has gained admission to the WTO and access to the more liberal trade regime currently being phased in, with an attendant rapid increase in its textile and apparel exports. The U.S. government has also entered into a free trade agreement with Jordan and Chile and proposed similar agreements with Singapore and certain African countries.

Labor Relations. Brookwood s Kenyon subsidiary has entered into a three-year collective bargaining agreement with the Union of Needletrades, Industrial and Textile Employees, representing approximately 256 employees at its Rhode Island plant facilities, effective from March 1, 2004. Management believes that overall relations with employees are good.

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 the 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.

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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.

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

	Years Ended December 31,		
	2003	2002	2001
Property management fees	$1,979	$2,029	$2,009
Leasing fees	1,556	2,151	2,158
Construction supervision fees	698	582	1,204
Asset management fees	605	618	609
Disposition fees			120
Total	$4,838	$5,380	$6,100

HSC Financial Corporation. The Company has entered into a financial 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 ($495,000 prior to May 2001 and $954,000 after February 2004). 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):

	Years Ended December 31,		
	2003	2002	2001
Consulting fees	$795	$795	$683
Office space and administrative services	104	98	86
Bonus	33	33	33
Total	$932	$926	$802

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.

Hallwood Investments Limited. During 2000 and 2001, the Company entered into loan agreements with Hallwood Investments Limited, an entity with which Mr. Gumbiner is associated, whereby the Company borrowed funds in the amount of $4,000,000. Several factors contributed to the Company s cash flow needs at the time, including difficulties experienced by the Company s hotel operations and restriction on the availability of distributions and tax-sharing payments from Brookwood. The loans bore an interest rate of 10% and were repaid by the Company in December 2001 and March 2002.

HEC. During 2002 and 2003, the Company invested $5,497,000 in HEC, a private energy company. In January 2004, the Company invested an additional $566,000 in HEC. 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.

Hallwood Exploration. In the 2004 first quarter, the Company invested $659,000 in Hallwood Exploration, a newly-formed, private energy company. The Company owns approximately 20% of Hallwood Exploration and accounts for the investment using the equity method of accounting. Certain of the Company s officers and directors are investors in Hallwood Exploration.

Brookwood. During 2000, Brookwood formed STA with an unrelated 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. Prior to October 2002, Brookwood reported sales to STA of $11,444,000 and $5,342,000 for the nine months ended September 30, 2002 and for the year ended December 31, 2001, respectively.

Financial Covenants

The Company s Amended and Restated Credit Agreement and 10% Debentures require compliance with various loan covenants and financial ratios, which, if not met, will trigger a default. The Amended and Restated Credit Agreement requires a minimum net cash flow, as defined, of $4,400,000, a minimum debt service coverage ratio, as defined, for each rolling four quarter period, a senior leverage ratio, as defined, and a minimum collateral value coverage. Additionally, Brookwood s Key Credit Agreement requires compliance with various loan covenants and financial ratios, principally a debt service coverage ratio and a debt to equity ratio. In January 2004, the Key Credit Agreement was renewed. The current ratio covenant and total funded debt to total capitalization ratio covenant were eliminated in the renewal. A total debt to tangible net worth ratio covenant was added.

Amended and Restated Credit Agreement. The principal ratios, as defined in the Amended and Restated Credit Agreement and the former Term Loan and Revolving Credit Facility, as of December 31, 2003 and the end of the interim quarters in the year ended December 31, 2003 are provided below (dollar amounts in thousands):

		Quarters Ended in 2003			
Description	**Required Amount**	**December 31,**	**September 30,**	**June 30,**	**March 31,**
Net cash flow, as defined	must exceed $4,400(a)	$8,869	$8,331	$6,967	$5,995
Debt service coverage	must exceed 1.2 to 1.0	2.18	2.22	1.97	1.77
Senior leverage	must be less than 2.5 to 1.0	1.51	1.58	1.81	1.41
Collateral value coverage	must exceed 200% of loan balance	349%	406%	733%	769%

(a) requirement was $3,400 prior to July 2003

The Company was in compliance with its loan covenants under the Amended and Restated Credit Agreement and the former Term Loan and Revolving Credit Facility as of December 31, 2003 and for all interim periods during 2003.

10% Debentures. The Indenture governing the 10% Debentures contains various covenants, which if violated, may result in a call of the entire issue. The principal covenants prohibit any subsidiary of the Company from commencing receivership, bankruptcy or insolvency proceedings. The Company was in compliance with its loan covenants for the 10% Debentures as of December 31, 2003 and for all interim periods during 2003.

Key Credit Agreement. The principal ratios, as defined in the Key Credit Agreement as of December 31, 2003 and the end of the interim quarters in the year ended December 31, 2003 are provided below:

		Quarters Ended in 2003			
Description	**Required Amount**	**December 31,**	**September 30,**	**June 30,**	**March 31,**
Current ratio	must exceed 1.40 to 1.00	1.60	1.60	1.60	1.70
EBITDA to total fixed charges	must exceed 1.25 to 1.00	1.44	2.29	2.06	2.22

Total funded debt to total capitalization	must be less than 45%	36%	38%	43%	40%

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Brookwood was in compliance with its loan covenants under the Key Credit Agreement as of December 31, 2003 and for all interim periods during 2003.

Number of Employees. The Company had 584 and 548 employees as of February 28, 2004 and 2003, comprised as follows:

	February 28,	
	2004	**2003**
Hallwood	5	5
Brookwood	459	425
HCRE	68	68
Hotel	30	28
Hallwood Realty	22	22
Total	584	548

A substantial amount of the salaries and related costs for the employees of HCRE and Hallwood Realty are reimbursed by HRP.

Brookwood s Kenyon subsidiary has entered into a three-year collective bargaining agreement with the Union of Needletrades, Industrial and Textile Employees, representing approximately 256 employees at its Rhode Island plant facilities, effective from March 1, 2004. Management believes that overall relations with employees are good.

Available Information

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

Executive Officers of the Company

In addition to Anthony J. Gumbiner, age 59, who serves as Director, Chairman and President, (see Item 10) the following individuals also serve as executive officers of the Company:

William L. Guzzetti, age 60, has served as Executive Vice President of the Company since October 1989. Mr. Guzzetti has served as President, Chief Operating Officer and a Director of Former Hallwood Energy from December 1998 until May 2001. He was President, Chief Operating Officer and a director of the general partner of Hallwood Energy Partners, L.P. from February 1985 until June 1999 and as President, Chief Operating Officer and a Director of Hallwood Consolidated Resource Corporation from May 1991 until June 1999. Since November 1990 and May 1991, Mr. Guzzetti has served as the President, Chief Operating Officer and a Director of Hallwood Realty and HCRE, respectively. He has served as the President and a director of HEC since December 2002. He is a member of the Florida Bar and the State Bar of Texas.

Melvin J. Melle, age 61, has served as Vice President and Chief Financial Officer of the Company since December 1984 and as Secretary of the Company since October 1987. Mr. Melle served as Assistant Secretary of the Company from December 1984 to October 1987. Mr. Melle had served as Secretary and Principal Financial and Accounting Officer of Alliance Bancorporation from April 1989 until its liquidation in February 1994. From June 1980 through June 1986, Mr. Melle served as Chief Financial Officer of The Twenty Seven Trust. Mr. Melle is a member of the American Institute of Certified Public Accountants and of the Ohio Society of Certified Public Accountants.

Amber M. Brookman, age 61, has served as President, Chief Executive Officer and Director of Brookwood since 1989.

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Item 2. ***Properties***

Real Properties

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

Cost of real estate owned by property type and geographic distribution (in thousands of dollars):

	December 31, 2003			
Property Type	**Operating Properties**	**Non-Operating Properties**	**Total**	**Percentage**
Dyeing and finishing plant Rhode Island(1)	$5,063	$	$5,063	91%
Hotel Alabama(2)	455		455	9
Parking Lot Texas(3)		50	50	*
Total	$5,518	$		