

HALLWOOD GROUP INC

Form 10-K

April 13, 2006

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

MARK ONE

- ANNUAL 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 Year Ended December 31, 2005**

**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:**

<b>Title of Class</b>	<b>Name of Each Exchange on Which Registered</b>
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Common Stock (\$0.10 par value)	American Stock Exchange
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**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 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.

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

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

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

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

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

**DOCUMENTS INCORPORATED BY REFERENCE**

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

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**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 formed in September 1981, is a holding company that operates in the textile products and energy business segments. The Company s former real estate and hotel business segments are reported as discontinued operations.

**Continuing Operations**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Net Production (Mcf/day)	850	850
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- a) Net acres held is the sum of the total number of acres in which Hallwood Energy owns a working interest multiplied by Hallwood Energy's fractional working interest.
- b) For East Arkansas, excludes in excess of 230,000 acres, which were under contract to be acquired, but for which title work has not yet been completed, some of which management believes will not ultimately be acquired.
- c) Oil and gas leases in Reeves and Culberson Counties. The primary objective formations are the Barnett Shale, which appears to range in depth from 12,300 to 16,500 feet and to have a thickness of 800 to 1000 feet; and the Woodford Shale, which appears to range in depth from 13,100 to 17,500 feet and to have a thickness of 200 to 600 feet, both in Reeves and Culberson Counties.
- d) Oil and gas leases in Parker and Tarrant Counties. The primary objective formation is the Barnett Shale, which appears to have a range in depth from 5,000 to 7,000 feet and to have a thickness of 200 to 400 feet.
- e) Acreage was acquired to exploit a salt dome oil and gas opportunity in St. James, Ascension and Assumption Parishes. Hallwood Energy has acquired mineral lease options, has conducted and processed a 3-D seismic survey over the optioned land. Based on the results of the 3-D seismic data that have been analyzed, approximately 4,000 - 8,000 acres are expected to be retained for future development.
- f) Oil and gas leases in nine counties. The primary objective formation is the Fayetteville Shale, which appears to range in depth from 2,700 to 7,400 feet and to have a thickness of 300 to 700 feet.

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

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

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

**Discontinued Operations**

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

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

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



approximately \$66,119,000 for its investments in HRP and related assets.

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*Hotels.* In December 2000, the Company decided to dispose of its hotel segment, which at that time consisted of five hotel properties. Accordingly, the Company's hotel operations were reclassified as a discontinued operation. Two hotels were disposed of in 2001 and two hotels were disposed of in 2002. The Company continued to operate a leasehold interest in one hotel until December 2004, when the hotel subsidiary entered into a Lease Termination and Mutual Release Agreement with the landlord. In connection with the lease termination, the remaining assets of the subsidiary were transferred to the landlord, and the Company obtained a release from any further obligations. As of December 31, 2004, the Company had no further operations associated with the hotel segment.

**Competition, Risks and Other Factors**

***The Company***

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

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

***Textile Products***

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

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

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

The military has recently indicated an intention to limit orders for existing products and to adopt revised specifications for new products to replace the products for which Brookwood's customers have been suppliers. While any change in specifications or orders presents a potential opportunity for additional sales, it is uncertain whether Brookwood's products will continue to comply with changing specifications as they are adopted. If Brookwood's products do not comply with the revised specifications, then it would not be able to supply those

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items. In addition, the U.S. government is releasing contracts for shorter periods than in the past. Therefore, the Company is unable at this time to predict future sale trends.

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

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

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

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

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

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

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



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

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

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

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

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

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

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

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



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

***Energy***

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

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

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

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

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

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

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





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

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

**Number of Employees**

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

	<b>February 28,</b>	
	<b>2006</b>	<b>2005</b>
Hallwood	10	14
Brookwood	452	481
Hallwood Petroleum		19
Total	462	514

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

**Available Information**

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

**Executive Officers of the Company**

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

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



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

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

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

**Item 2. Properties****Real Properties**

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

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

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

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

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

**Leased Facilities**

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

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

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

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

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

**Table of Contents****Item 3. Legal Proceedings**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

**Years Ended December 31,**

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

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

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

**Table of Contents****Item 6. Selected Financial Data**

	Years Ended December 31,				
	2005	2004	2003	2002	2001
	(In thousands, except per share data)				
Revenues	\$ 134,607	\$ 137,280	\$ 104,720	\$ 84,770	\$ 68,894
Expenses	134,554	125,609	100,145	84,702	71,383
Operating income (loss)	53	11,671	4,575	68	(2,489)
Other income (loss):					
Gains from disposition of HE III and HEC(a)	52,312	62,288			
Other, net	1,532	2,918	2,390	2,940	(467)
Equity income (loss) from investments in energy affiliates	(8,500)	(9,901)	50	(187)	
Interest expense	(545)	(1,197)	(1,636)	(1,392)	(3,116)
	44,799	54,108	804	1,361	(3,583)
Income (loss) from continuing operations before income taxes	44,852	65,779	5,379	1,429	(6,072)
Income tax expense	18,510	11,079	1,725	1,435	1,658
Income (loss) from continuing operations	26,342	54,700	3,654	(6)	(7,730)
Income (loss) from discontinued operations, net of tax:					
Income from real estate operations(b)		39,002	4,339	3,720	2,402
Income (loss) from hotel operations(c)		783	(568)	3,080	(1,521)
Income from energy operations(d)					11,134
		39,785	3,771	6,800	12,015
Income before cumulative effect of change in accounting principles	26,342	94,485	7,425	6,794	4,285
Income (loss) from cumulative effect of change in accounting principles(e)				568	(40)
<b>Net Income</b>	<b>\$ 26,342</b>	<b>\$ 94,485</b>	<b>\$ 7,425</b>	<b>\$ 7,362</b>	<b>\$ 4,245</b>
<b>Income (Loss) from Continuing Operations Per Common Share</b>					
Basic	\$ 18.22	\$ 41.24	\$ 2.68	\$ (0.04)	\$ (5.48)
Assuming dilution	17.47	36.79	2.59	(0.02)	(5.48)
<b>Net Income Per Common Share</b>					
Basic	\$ 18.22	\$ 71.24	\$ 5.47	\$ 5.37	\$ 2.95
Assuming dilution	17.47	63.55	5.30	5.19	2.95
<b>Dividends Per Common Share</b>	<b>\$ 43.87</b>				
<b>Weighted Average Shares Outstanding</b>					

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Basic	1,446	1,326	1,347	1,361	1,420
Assuming dilution	1,508	1,487	1,390	1,415	1,420
<b>Financial Condition</b>					
Total assets	\$ 108,801	\$ 157,317	\$ 83,554	\$ 69,548	\$ 77,567
Loans and capital lease obligations	6,812	9,136	23,938	17,130	30,750
Redeemable preferred stock	1,000	1,000	1,000	1,000	1,000
10% Debentures			6,569	6,625	6,677
Common stockholders equity	88,443	124,541	29,829	23,136	15,883

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- (a) In July 2005, the Company sold its investment in HE III. In December 2004, the Company sold its investment in HEC.
- (b) In July 2004, the Company sold its investments in HRP.
- (c) The Company has reported its hotel business segment as discontinued; however, it retained a leasehold interest in one hotel which remained a continuing asset until it was terminated in December 2004.
- (d) In May 2001, the Company sold its investment in Former Hallwood Energy.
- (e) SFAS No. 142 became effective on January 1, 2002, which resulted in the Company recording income in 2002 of \$568,000, which represented negative goodwill associated with the Company's HRP investment. Results for calendar 2001 included a loss from adoption of SFAS No. 133.

**Item 7. *Management's Discussion and Analysis of Financial Condition and Results of Operations***  
**Overview**

*General.* Until July 2004, the Company was a diversified holding company with interests in textiles, real estate and energy. Since that time, the Company disposed of its interests in HRP in July 2004, which constituted substantially all of its real estate activities, and HEC and HE III in December 2004 and July 2005, respectively. The Company received total cash proceeds from these transactions of approximately \$178,000,000, including approximately \$55,000,000 from the disposition of HE III in July 2005. These proceeds were used to repay bank debt, the Company's 10% Debentures and other obligations and make further investments in the Company's energy affiliates. In addition, the Company paid cash dividends to its common stockholders of approximately \$56,789,000, \$37.70 per share, on May 27, 2005, and approximately \$9,324,000, \$6.17 per share, on August 18, 2005. The Company had approximately \$16,648,000 in cash and cash equivalents at December 31, 2005.

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

*Continuing Operations.* The Company derives substantially all of its revenues from continuing operations from its Brookwood subsidiary; consequently, the Company's success is highly dependent upon Brookwood's success. Brookwood's success will be influenced in varying degrees by its ability to continue sales to existing customers, cost and availability of supplies, its response to competition, its ability to generate new markets and products and the effect of global trade regulations.

While Brookwood has enjoyed substantial growth in its military business during the past three years, there is no assurance this trend will continue. Brookwood's sales to the customers from whom it derives its military business have been more volatile and difficult to predict, a trend the Company believes will continue. Military sales of \$72,456,000 for the 2005 calendar year were 5% lower than the comparable period in 2004. In recent years, orders from the military for goods generally were significantly affected by the increased activity of the U.S. military. If this activity does not continue or declines, then orders from the military generally, including orders for Brookwood's products, may be similarly affected.

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



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

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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 and other materials, which have been well received by its customers. Continued development of these fabrics for military, industrial and consumer applications is a key element of Brookwood's business plan. The ongoing enterprise value of Brookwood is contingent on its ability to maintain its level of military business and adapt to the global textile industry; however, there can be no assurance that the positive results of the past can be sustained or that competitors will not aggressively seek to replace products developed by Brookwood.

The textile industry is also significantly affected by legislation and administrative actions restricting or liberalizing trade among world textile producing and consuming countries such as the North American Free Trade Agreement (NAFTA), the World Trade Organization (WTO), the anti-dumping and countervailing duty remedies and enforcement activities by the U.S. Government, and the value of the United States dollar in relation to other currencies and world economic developments. However, under NAFTA there are no textile and apparel quotas between the U.S. and either Mexico or Canada for products that meet certain origin criteria. Tariffs among the three countries are either already zero or are being phased out. Also, the WTO recently phased out textile and apparel quotas.

The U.S. has also approved the Central American Free Trade Agreement (CAFTA) with five Central American countries (Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua). Under CAFTA, textile and apparel originating from CAFTA countries will be duty and quota-free, provided that yarn formed in the United States or other CAFTA countries is used to produce the fabric. In addition, the United States recently implemented bilateral free trade agreements with Australia, Bahrain, Chile, Israel, Jordan, Morocco and Singapore. Although these actions have the effect of exposing Brookwood's market to the lower price structures of the other countries and, therefore, continuing to increase competitive pressures, management is not able to predict their specific impact.

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

*Energy.* Since January 2002, the Company has invested over \$59,700,000 in various energy affiliates, of which \$6,063,000 related to HEC, which was sold in December 2004 and \$10,951,000 related to HE III, which was sold in July 2005. Following the sale of HEC and HE III, the remaining principal affiliates were HE II, HE 4 and Hallwood Exploration. The Company owned between 20% and 28% of the entities (between 16% and 22% on a fully diluted basis) and accounted for the investments using the equity method of accounting, recording its pro rata share of net income (loss), stockholders' equity/partners' capital transactions and comprehensive income (loss). Through 2005, these private companies were or have been principally involved in acquiring oil and gas leases and drilling, gathering and sale of natural gas in the Barnett Shale formation of Johnson County, Texas and surrounding counties and the Barnett Shale and Woodford Shale formations in West Texas, conducting 3-D seismic surveys over optioned land covering a Salt Dome in South Louisiana in order to determine how best to proceed with exploratory activity and acquiring oil and gas leases in the Fayetteville Shale formation of East Arkansas. Effective December 31, 2005, the remaining private energy affiliates, were consolidated into HE 4, which was renamed Hallwood Energy. The Company owns approximately 26% (22% after consideration of profits interests) of Hallwood Energy.

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

*Discontinued Operations.* The Company's real estate activities were conducted primarily through certain wholly owned subsidiaries. One of the subsidiaries served as the general partner of HRP, a publicly traded master limited partnership and another served as property manager. Revenues were generated from the receipt of management fees, leasing commissions and other fees from HRP and third parties and the Company's 22% pro rata share of earnings of HRP using the equity method of accounting.

In July 2004, HRP was merged with a subsidiary of HRPT. As a result, HRP became a wholly-owned subsidiary of HRPT and was no longer a publicly traded limited partnership. The general partner interest in

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HRP was also sold to a HRPT subsidiary in a separate transaction and the management agreements for the properties were terminated. The Company no longer holds any interest in HRP. The Company received \$66,119,000 for its investments in HRP and related assets.

In December 2000, the Company decided to dispose of its hotel segment, which at that time consisted of five hotel properties. Accordingly, the Company's hotel operations were reclassified as a discontinued operation. Two hotels were disposed of in 2001 and two hotels were disposed of in 2002. The Company continued to operate a leasehold interest in one hotel until December 2004, when the hotel subsidiary entered into a Lease Termination and Mutual Release Agreement. As of December 31, 2004, the Company had no further operations associated with the hotel segment.

**Critical Accounting Policies**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and judgments that affect the reported amounts of certain assets, liabilities, revenues, expenses, and related disclosures. Actual results may differ from these estimates under different assumptions or conditions.

In December 2001, the Securities and Exchange Commission ( SEC ) requested that registrants identify critical accounting policies in Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations. The SEC indicated that a critical accounting policy is one that is both important to the portrayal of an entity's financial condition and results and requires management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. The Company believes that the following of its accounting policies fit this description:

*Revenue Recognition.* Textile products sales are recognized upon shipment or release of product, when title passes to the customer. Brookwood provides allowances for expected cash discounts, returns, claims and doubtful accounts based upon historical bad debt and claims experience and periodic evaluation of the aging of accounts receivable. If the financial condition of Brookwood's customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances would be required.

On occasion, Brookwood receives instructions from some of its customers to finish fabric, invoice the full amount and hold the finished inventory until the customer sends shipping instructions. In those cases, Brookwood records the sale and sends the customer an invoice containing normal and usual payment terms and identifies the inventory as separate from Brookwood's inventory. Generally, a customer provides such instructions to accommodate its lack of available storage space for inventory. This practice is customary in the textile industry and with respect to certain Brookwood customers. In these cases, the Brookwood customer either dictates delivery dates at the time the order is placed or when the customer has not specified a fixed delivery date, the customer owns the goods and has asked Brookwood to keep them in the warehouse until the customer provides a delivery date. For all of its bill and hold sales, Brookwood has no future obligations, the customer is billed when the product is ready for shipment and expected to pay under standard billing and credit terms, regardless of the actual delivery date, and the inventory is identified and not available for Brookwood's use. Brookwood's total bill and hold sales in 2005 were less than one percent of sales. The bill and hold inventory held for customers at December 31, 2005, was approximately \$107,000.

*Deferred Income Tax Asset.* A deferred income tax asset is recognized for net operating loss and certain other tax carryforwards, tax credits and temporary differences, reduced by a valuation allowance, which is established when it is more likely than not that some portion or all of the asset will not be realized. Management is required to estimate taxable income for future years and to use its judgment to determine whether or not to record a valuation allowance to reduce part or all of a deferred tax asset. Management considered various tax planning strategies, anticipated gains from the potential sale of investments and projected income from operations to determine the valuation allowance to be recorded. As a result of the significant taxable income reported in 2004 and projected taxable income, management eliminated its valuation allowance during 2004.

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*Impairment of Long-Lived Assets.* Management routinely reviews its investments for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Unforeseen events and changes in circumstances and market conditions could negatively affect the fair value of assets and result in an impairment charge. In the event such indicators exist for assets held for use, if undiscounted cash flows before interest charges are less than carrying value, the asset is written down to estimated fair value. For assets held for sale, these assets are carried at the lower of cost or estimated sales price less costs of sale. Fair value is the amount at which the asset could be bought or sold in a current transaction between willing parties and may be estimated using a number of techniques, including quoted market prices or valuations by third parties, present value techniques based on estimates of cash flows, or multiples of earnings or revenues performance measures. The fair value of the asset could be different using different estimates and assumptions in these valuation techniques. Significant assumptions used in this process depend upon the nature of the investment, but would include an evaluation of the future business opportunities, sources of competition, advancement of technology and its impact on patents and processes, future rental and occupancy rates, and the level of expected operating expenses.

*Inventories.* Inventories at the Brookwood subsidiary are valued at the lower of cost (first-in, first-out or specific identification method) or market. Inventories are reviewed and adjusted for changes in market value based on assumptions related to future demand and worldwide and local market conditions. If actual demand and market conditions vary from those projected by management, adjustments to lower of cost or market value may be required.

The policies listed are not intended to be a comprehensive list of all of our accounting policies. In most cases, the accounting treatment of a particular transaction is specifically dictated by accounting principles generally accepted in the United States of America, with no need for management's judgment in the application. There are also areas in which management's judgment in selecting any available alternative would not produce a materially different result than those recorded and reported.

**Presentation**

The Company intends the discussion of its financial condition and results of operations that follows to provide information that will assist in understanding its financial statements, the changes in certain key items in those financial statements from year to year, and the primary factors that accounted for those changes, as well as how certain accounting principles, policies and estimates affect its financial statements.

**Results of Operations**

The Company reported net income of \$26,342,000 for the year ended December 31, 2005, compared to \$94,485,000 for 2004, and \$7,425,000 for 2003. Income from continuing operations was \$26,342,000 for 2005, compared to \$54,700,000 for 2004 and \$3,654,000 for 2003. Revenue from continuing operations was \$134,607,000 for 2005, \$137,280,000 for 2004 and \$104,720,000 for 2003. Income from discontinued operations was \$39,785,000 for 2004 and \$3,771,000 for 2003.

**Revenues**

Textile products sales of \$133,108,000 in 2005 decreased by \$3,168,000, or 2.3%, compared to \$136,276,000 in 2004, which was an increase of \$31,556,000, or 30.1%, compared to \$104,720,000 in 2003. The 2005 decrease was principally due to a decline of \$3,443,000 in sales of specialty fabric to U.S. military contractors as a result of decreased orders from the military to Brookwood's customers. The 2004 increase was principally due to additional sales in the amount of \$29,902,000 of specialty fabric to U.S. military contractors, as a result of increased orders from the military to Brookwood's customers because of the increased activity of the U.S. military in recent years. In addition, Brookwood has developed and marketed products and upgraded equipment.

The Company's former Hallwood Petroleum, LLC subsidiary ( HPL ) commenced operations in October 2004 as an administrative and management company to facilitate recordkeeping and processing for the energy affiliates. All costs were rebilled to energy affiliates with no anticipated profit element. In the 2005

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second quarter, the Company determined that its ownership of this pass-through entity created unnecessary complexity; therefore, HPL was transferred for nominal consideration to officers of the energy affiliates that are not officers of the Company. The transfer was completed on May 11, 2005. Administrative fees from energy affiliates in 2005 were \$1,499,000 beginning January 2005 through the transfer date.

**Expenses**

Textile products cost of sales increased \$2,527,000 to \$105,299,000, or 2.5%, in 2005. The 2004 cost of sales of \$102,772,000 increased by \$19,510,000, or 23.4%, compared to \$83,262,000 in 2003. The 2005 increase was principally attributable to the increased cost of outside processing for laminated products of approximately \$500,000, increased energy costs of approximately \$459,000 and general increases in volume. Cost of sales includes all costs associated with the manufacturing process, including but not limited to, materials, labor, utilities, depreciation on manufacturing equipment and all costs associated with the purchase, receipt and transportation of good and materials to Brookwood's facilities, including inbound freight, purchasing and receiving costs, inspection costs, internal transfer costs and other costs of the distribution network. Brookwood believes that the reporting and composition of cost of sales and gross margin is comparable with similar companies in the textile converting and finishing industry.

The gross profit margin was 20.9%, 24.6% and 20.5% in 2005, 2004 and 2003, respectively. The reduced gross profit margin for 2005 principally resulted from changes in product mix and higher outside processing costs for laminated products and higher energy costs. The improved gross profit margin in 2004 resulted from the sales increase of specialty fabric to U.S. military contractors and improved manufacturing efficiencies.

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

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
Textile products	\$ 16,132	\$ 15,043	\$ 14,787
Corporate	11,624	6,792	2,096
Energy	1,499	1,002	
 Total	 \$ 29,255	 \$ 22,837	 \$ 16,883

Textile products administrative and selling expenses of \$16,132,000 for 2005 increased by \$1,089,000, or 7.2%, from the 2004 amount of \$15,043,000, which increased \$256,000, or 1.7%, compared to the 2003 amount of \$14,787,000. The 2005 increase was primarily due to higher insurance, salaries, shipping and administrative costs of \$334,000, \$260,000, \$263,000 and \$367,000, respectively, which were partially offset by lower professional expense and lower computer software related expenses. The 2004 increase was primarily attributable to higher royalty and payroll costs and costs associated with the implementation of the Sarbanes-Oxley Act of 2002. The textile products administrative and selling expenses included items such as payroll, professional fees, sales commissions, marketing, rent, insurance, travel and royalties. Brookwood conducts research and development activities related to the exploration, development and production of innovative products and technologies. However, such costs were not significant during the periods presented. Research and development expenses were approximately \$335,000 in 2005 and were not significant in 2004 and 2003.

Corporate administrative expenses were \$11,624,000 for 2005, compared to \$6,792,000 for 2004 and \$2,096,000 for 2003. The 2005 increase of \$4,832,000 was primarily attributable to bonus awards of \$5,000,000 to Mr. Gumbiner and \$1,340,000 to those officers of the Company, other than Mr. Gumbiner, who held options to purchase common stock in lieu of cash dividends such holders would have received had they exercised their options prior to the record dates, and increased professional fees, partially offset by the bonuses to the Hallwood Realty employees in 2004. The 2004 expenses include increased professional fees, travel expenses and costs associated with the merger of HRP with HRPT, including costs of \$2,465,000 associated with a plan to offer employment and pay retention bonuses to eight

former Hallwood Realty employees to remain available for assisting in the winding up of HRP's business and to assist the Company in the pursuit of new real estate opportunities in the future and executive bonuses associated with the disposition of HEC.

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Administrative costs attributable to HPL, which commenced operations in October 2004, were \$1,499,000 for the period from January 1, 2005 to the May 11, 2005 date of transfer.

**Other Income (Loss)**

The Company reported a gain from the July 2005 disposition of its investment in HE III in the amount of \$52,425,000. HE III completed a merger with Chesapeake for \$246,500,000, subject to reduction for outstanding debt, transaction costs, changes in working capital and certain other matters. After the adjustment and the repayment of debt of HE III, the Company received cash proceeds totaling \$54,850,000 in July 2005. In addition, the Company received \$799,000 in November 2005 from the final working capital adjustment. The net investment in HE III at the date of sale was \$3,693,000.

On December 15, 2004, HEC completed a merger with Chesapeake Energy Corporation for \$292,000,000, subject to reduction for certain transaction costs, title discrepancies and other matters. After the adjustment and the repayment of certain loans and other obligations of HEC, the Company received cash proceeds totaling \$55,788,000. The Company reported a gain from sale of investment in HEC of \$62,288,000 in 2004. The gain from sale exceeded the proceeds, due to the recording of equity losses from HEC operations which reduced the carrying value of the HEC investment below zero. The Company had recorded a receivable for \$500,000 for the anticipated additional amount the Company would receive from the disposition of its HEC investment upon final calculation of HEC's working capital. In April 2005, the Company received \$387,000 as its proportionate share of the working capital. Accordingly, the Company reduced the gain from the disposition of HEC by \$113,000 in the 2005 first quarter.

Interest and other income (expense) was \$1,532,000 in 2005, compared to \$1,536,000 in 2004 and \$(27,000) in 2003. The 2005 decrease was principally due to a decline in income from investments in marketable securities to \$185,000 in 2005 from \$1,132,000 in 2004, offset by substantially higher interest income on its cash and cash equivalents. The 2004 increase was due to income gains from investments in marketable securities and interest income earned on cash and cash equivalents.

Amortization of deferred revenue in the amount of \$1,007,000 in 2004 and \$2,417,000 in 2003 was attributable to the noncompetition agreement associated with the sale of the Company's investment in Former Hallwood Energy in May 2001. Under the noncompetition agreement, the Company agreed to refrain from taking certain actions without prior consent, including, among other items, directly or indirectly engaging in certain oil and gas activities in certain geographic areas, for a period of three years. The original \$7,250,000 cash payment was amortized over a three year period which ended in May 2004.

In 1999, the Company entered into a separation agreement (the Separation Agreement) with a former officer and director. The Company had an option to extinguish the future cash payments at any time prior to December 21, 2004 upon the payment of \$3,000,000. In June 2004, the Company exercised the option. The Company recognized a gain from extinguishment of the Separation Agreement in the amount of \$375,000, which was the excess of the remaining obligation over the \$3,000,000 exercise price.

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

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
HE III	\$ (8,628)	\$ (223)	\$
HE II	417	(6)	
Hallwood Exploration	(165)	(228)	
HE 4	(124)		
HEC		(9,444)	50
Total	\$ (8,500)	\$ (9,901)	\$ 50





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The Company recorded its proportionate share of HE III's 2005 loss, principally attributable to compensation expense in connection with the settlement of profits interests with certain HE III executives, concurrent with the completion of the merger and sale in July 2005.

In connection with the July 2005 disposition of HE III, HE II sold all of its 835 net acres lease holdings in Johnson County, Texas to Chesapeake for \$3,000,000. The gain from this transaction was included in the Company's proportionate share of HE II's income for the year.

In March 2005, an agreement was entered into with a former officer of the energy affiliates, who was not otherwise affiliated with the Company, to purchase the officer's four percent profit interest in the energy affiliates for \$4,000,000, of which \$3,500,000 was ascribed to HE III and \$250,000 each to HE II and Hallwood Exploration. The purchase amount was recorded as compensation expense and the Company recorded its proportionate share, approximately \$1,100,000, through equity accounting.

The Company's proportionate share of HEC's 2004 loss was principally attributable to compensation expense in connection with the settlement of stock options concurrent with the completion of the merger and sale in December 2004.

Interest expense was comprised of the following (in thousands):

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
Textile products	\$ 545	\$ 398	\$ 641
Corporate		799	995
<b>Total</b>	<b>\$ 545</b>	<b>\$ 1,197</b>	<b>\$ 1,636</b>

Textile products interest expense principally relates to Brookwood's Key Bank revolving credit facility. Fluctuations in interest expense year to year were principally due to changes in the average outstanding amounts and increasing interest rates.

Corporate interest expense in 2004 and 2003 principally related to the Company's Amended and Restated Credit Agreement, the former Term Loan and Revolving Credit Facility and the 10% Debentures. All corporate level debt was repaid during 2004. Interest expense of \$799,000 in 2004 decreased by \$196,000, or 20%, due to the repayment of the Amended and Restated Credit Agreement in July 2004 and the redemption of the 10% Debentures in September 2004.

**Income Taxes**

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

<b>Continuing Operations</b>	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
<b>Federal</b>			
Current	\$ 13,688	\$ 10,390	\$ (5)
Deferred	3,933	(900)	822
Sub-total	17,621	9,490	817
<b>State</b>			
Current	779	1,783	908
Deferred	110	(194)	

Sub-total	889	1,589	908
Total	\$ 18,510	\$ 11,079	\$ 1,725

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<b>Discontinued Operations</b>	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
<b>Federal</b>			
Current	\$	\$ 1,207	\$ 73
Deferred		5,143	(5,307)
Sub-total		6,350	(5,234)
<b>State</b>		212	40
Total	\$	\$ 6,562	\$ (5,194)

The increased 2005 and 2004 amounts from continuing operations are attributable to significant taxable income, principally related to the gains from the sale of HE III and HEC, respectively. Income tax expense in 2005 includes a limitation on the deductibility of executive compensation.

The 2004 federal deferred tax expense from discontinued operations of \$5,143,000 was principally attributable to the utilization of NOLs, depletion carryovers and tax credits to offset the gain from the sale of HRP. The 2003 federal deferred tax benefit of \$5,307,000 was principally attributable to the anticipated utilization of NOLs, depletion carryovers and tax credits that were previously reserved, to offset the increase in fair value of its general partner and limited partner interests in HRP.

During 2004, the Company utilized all of its available NOLs, depletion carryovers and tax credits to offset taxable income. Accordingly, at December 31, 2005 and 2004, the deferred tax asset is attributable solely to temporary differences, that upon reversal, can be utilized to offset income from operations.

Although the use of such carryforwards in 2004 to offset taxable income could have been limited if changes in the Company's stock ownership had created a change of control, as provided in Section 382 of the Internal Revenue Code of 1986, as amended, the Company believes no such changes have occurred.

**Table of Contents****Discontinued Operations Real Estate**

A summary of discontinued real estate operations as a result of the sale of its investments in HRP and the termination of the associated management contracts (through the date of sale) is provided below (in thousands):

	Years Ended December 31,		
	2005	2004	2003
<b>Revenues</b>			
Fees			
Related parties	\$	\$ 2,814	\$ 4,838
Other		247	238
Equity loss from investments in HRP		(2,769)	(436)
		292	4,640
<b>Expenses</b>			
Administrative expenses		877	1,564
Litigation costs		50	3,371
Amortization			560
		927	5,495
Loss from operations		(635)	(855)
<b>Gain from sale</b>			
Gain from sale of investments in HRP		52,703	
Incentive compensation and transaction costs		(6,629)	
		46,074	
Income (loss) before income taxes		45,439	(855)
Income taxes			
Current federal and state income tax expense		1,294	113
Deferred federal income tax expense (benefit)		5,143	(5,307)
		6,437	(5,194)
Income from discontinued real estate operations	\$	\$ 39,002	\$ 4,339

*Revenues.* Fee income of \$3,061,000 for 2004 decreased by \$2,015,000, or 40%, compared to \$5,076,000 for 2003. The decrease was principally due to the sale of HRP in July 2004. The Company's Hallwood Realty subsidiary was the general partner of HRP and earned an asset management fee and other fees from HRP properties, which amounted to \$335,000 for 2004 and \$605,000 for 2003. The Company's HCRE subsidiary was responsible for day-to-day on-site property management at all of HRP's properties and other properties it managed for third parties, for which HCRE received management fees, leasing commissions and certain other fees, which amounted to \$2,479,000 for 2004 and \$4,233,000 for 2003.

The equity loss from investments in HRP represents the Company's proportionate share of the net loss reported by HRP, adjusted for the elimination of intercompany income. The Company recorded an equity loss of \$2,769,000 for

2004, compared to a loss of \$436,000 in 2003. The 2004 decrease resulted principally from costs at HRP attributed to expenses associated with the settlement of unit options by HRP executives, employee severance costs, costs associated with the completion of the sale and resolution of litigation matters.

*Expenses.* Administrative expenses decreased by \$687,000, or 44%, to \$877,000 for 2004, compared to \$1,564,000 for 2003. The decrease was principally due to the sale of HRP in July 2004.

Litigation expense of \$3,371,000 in 2003 represented the interest component of the judgment on remand in the *Gotham Partners, L.P. vs. Hallwood Realty Partners, L.P. et al* matter discussed in Note 20, net of the

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Company's pro rata share of that amount which was recorded as income by HRP, and the Company's share of attorneys fees paid by HRP to plaintiff's attorneys recorded as expenses by HRP. Pursuant to the judgment on remand, the Company was required to pay a judgment of \$2,988,000 plus pre-judgment interest of approximately \$3,762,000. The Company paid \$5,000,000 of the combined amount in August 2003. In May 2004, the Company made an additional payment of \$1,877,000, including interest, in full satisfaction and obligation.

Amortization expense of \$560,000 in 2003 related to Hallwood Realty's general partner interest in HRP to the extent allocated to management rights, which was amortized over a ten year period and became fully amortized in October 2003.

*Gain from Sale of Investments in HRP.* The gain from sale of investments in HRP of \$52,703,000 resulted from the net proceeds of approximately \$66,119,000 received in the merger less the carrying value of the investments in the general partnership and limited partnership interests of approximately \$13,416,000.

*Incentive Compensation and Transaction Costs.* In connection with the sale of HRP and the substantial benefits the Company received from the operations of HRP over a number of years, a special committee, consisting of independent members of the board of directors of the Company authorized an additional incentive compensation payment of \$1,622,000 to Mr. William L. Guzzetti, the Company's President, and payments of \$1,908,000 to Mr. Gumbiner and \$3,000,000 to HIL. Transaction costs were \$99,000.

**Related Party Transactions**

*Hallwood Investments Limited.* The Company has entered into a financial consulting contract with HIL, a corporation associated with Mr. Gumbiner. The contract provides for HIL to furnish and perform international consulting and advisory services to the Company and its subsidiaries, including strategic planning and merger activities, for annual compensation of \$996,000 (\$954,000 prior to March 2005 and \$795,000 prior to March 2004). The annual amount is payable in monthly installments. The contract automatically renews for one-year periods if not terminated by the parties beforehand. Additionally, HIL and Mr. Gumbiner are also eligible for bonuses from the Company or its subsidiaries, subject to approval by the Company's or its subsidiaries' board of directors. The Company also reimburses HIL for reasonable expenses in providing office space and administrative services. A summary of the fees and expenses related to HIL and Mr. Gumbiner are detailed below (in thousands):

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
Bonus	\$ 5,000	\$ 4,908	\$ 33
Consulting fees	989	928	795
Office space and administrative services	557	324	104
Total	\$ 6,546	\$ 6,160	\$ 932

A special committee, consisting of independent members of the board of directors, awarded a \$5,000,000 bonus to Mr. Gumbiner, in consideration of the significant profits and long-term gains realized by the Company as a result of Mr. Gumbiner's performance over an extended period. The bonus was paid in July 2005.

In connection with the sale of HRP in July 2004 and the substantial benefits the Company received from the operations of HRP over a number of years, a special committee authorized additional incentive compensation payments of \$1,908,000 to Mr. Gumbiner and \$3,000,000 to HIL. The bonuses were paid in September and October 2004, respectively. As these incentive compensation payments related to HRP, the costs were reported within discontinued real estate operations.

In March 2004 the board of directors awarded HIL a bonus of \$33,000 from its HCRE subsidiary which was accrued in 2003.



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In addition, HIL and Mr. Gumbiner perform services for certain affiliated entities that are not subsidiaries of the Company, for which they receive consulting fees, bonuses, stock options, net profit interests or other forms of compensation and expenses. The Company recognizes a proportionate share of such compensation and expenses, based upon its ownership percentage in the affiliated entities, through the utilization of the equity method of accounting.

Beginning January 1, 2005, HIL shares common offices, facilities and certain staff in its Dallas office with the Company. The Company pays certain common general and administrative expenses and charges HIL an overhead reimbursement fee for its allocable share of the expenses. For the year ended December 31, 2005, HIL reimbursed the Company \$113,000 for such expenses.

*Hallwood Energy.* Beginning August 1, 2005, Hallwood Energy and its predecessor entities share common offices, facilities and certain staff in its Dallas office with the Company. Hallwood Energy reimburses the Company for its allocable share of the expenses. For the five month period ended December 31, 2005, Hallwood Energy reimbursed the Company \$59,000 for such expenses.

*Hallwood Realty Partners, L.P.* The Company's former Hallwood Realty and HCRE real estate subsidiaries earned asset management, property management, leasing and construction supervision fees for their management of HRP's properties. The management contracts with HRP were terminated on July 16, 2004 in connection with HRP's sale to HRPT.

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

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
Property management fees	\$	\$ 1,127	\$ 1,979
Leasing fees		866	1,556
Construction supervision fees		486	698
Asset management fees		335	605
<b>Total</b>	<b>\$</b>	<b>\$ 2,814</b>	<b>\$ 4,838</b>

Hallwood Realty was 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 did not employ any individuals, the compensation and other costs related to approximately 90 employees rendering services on behalf of HRP and its properties were reimbursed to Hallwood Realty and HCRE by HRP.

**Investments in Energy Affiliates**

On December 31, 2005, the Company had investments in three energy affiliates; HE II, HE 4 and Hallwood Exploration. Investments in other two energy affiliates, HEC and HE III, were sold in December 2004 and July 2005, respectively. Effective December 31, 2005, the remaining private energy affiliates, HE II, HE 4 and Hallwood Exploration were consolidated into HE 4, which was renamed Hallwood Energy. The Company owns approximately 26% (22% after consideration of profits interests) of Hallwood Energy.

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

<b>Entity</b>	<b>Amount</b>
HE 4	\$ 22,325
HE II	14,011



Hallwood Exploration	4,624
Total	\$ 40,960

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The following table reflects the results of completed oil and gas investments and status of current oil and gas investments by the Company since 2002. Forward looking information, including information concerning anticipated expenditures and budgeted drilling, is from current estimates by the management of Hallwood Energy, based on existing and anticipated conditions. Actual expenditures and activity may vary widely depending on a number of factors, including the availability and cost of drilling rigs, personnel and other services, regulatory requirements, the success of wells previously drilled by the energy entities and third parties, and other risks and uncertainties described in the section entitled Business Competition, Risks and Other Factors .

Description	Hallwood Energy						Total
	HEC	HE III	Delaware Basin Texas(a)	Fort Worth Basin Texas(a)	South Louisiana(b)	East Arkansas(c)	
Principal focus	Barnett Shale, Johnson County, Texas	Barnett Shale, Johnson County, Texas	Barnett and Woodford Shale	Barnett Shale	Salt Dome	Fayetteville Shale	
Initial funding	1 <sup>st</sup> Quarter 2002	2 <sup>nd</sup> Quarter 2004(d)	3 <sup>rd</sup> Quarter 2004	3 <sup>rd</sup> Quarter 2004	1 <sup>st</sup> Quarter 2004	3 <sup>rd</sup> Quarter 2005	
Company investment(e)	\$3,581,000(g)	\$12,544,000(h)					\$40,960,000(i)
Company ownership percentage(j)	28%/22%	28%/24%					26%/22%
Net acres held(e)	15,000	14,000	43,200	1,700	(k)	270,000	
Oil and gas wells drilled(e)(f)	44(i)	36(i)		2			2
Producing wells(e)(m)	43	36		2			2
Wells in drilling stage			2	1		1	4
Wells in completing/connecting stage(f)				2			2
Net production (Mcf/day)(e)	20,000	21,000		850			850
Month/year sold	December 2004	July 2005					
Sales proceeds to Company	\$56,175,000	\$55,649,000(h)					
Additional partner investment budgeted through							

December 31, 2006:						
Total						\$50,000,000
Company share(n)						\$13,200,000
Budget through December 31, 2006:						
Number of wells to be drilled(f)	8	12	6	39	65	
Capital expenditures	\$75,700,000	\$34,700,000	\$19,800,000	\$206,800,00	\$337,000,000	

- a) Formerly part of HE II
- b) Formerly part of Hallwood Exploration
- c) Formerly part of HE 4
- d) Date that HE III was separated from HEC.
- e) Information is as of the date of the sale for each of HEC and HE III and as of March 1, 2006 for the other properties. For East Arkansas excludes in excess of 230,000 acres, which were under contract to be acquired, but for which title work has not been completed, some of which management believes will not ultimately be acquired. Net acres held is the sum of the total number of acres in which Hallwood Energy owns a working interest multiplied by Hallwood Energy's fractional working interest.
- f) Represents the total gross number of wells in which Hallwood Energy holds a working interest.

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- g) Excludes the sale to HE III of gas properties in June 2004 at its carrying value of \$1,232,000 and a distribution to the partners of HEC of an interest in a saltwater disposal well at its carrying value of \$1,250,000 in connection with the sale of HEC in December 2004, and recontributed to HE III.
- h) Includes \$1,995,000 of debt, and \$1,250,000, representing the saltwater disposal well which was distributed to shareholders of HEC and contributed to HE III and excludes \$889,000 of pipe inventory distributed to the Company by HE III in connection with the sale of HE III in July 2005 and recontributed to HE II.
- i) Includes \$889,000 of pipe inventory distributed to the Company by HE III in connection with the HE III sale in July 2005, and recontributed to HE II.
- j) Before and after consideration of profits interests held by management.
- k) Hallwood Energy holds options to acquire leases on approximately 36,000 acres. Based on the results of 3-D seismic data that have been analyzed, approximately 4,000-8,000 acres are expected to be retained for future development.
- l) Consists of 13 horizontal wells and 31 vertical wells for HEC, and 31 horizontal wells and 5 vertical wells for HE III.
- m) Includes only wells drilled to total depth and includes wells in the process of completion.
- n) Represents the Company's proportionate share of capital contributions currently budgeted by the Hallwood Energy. These budgets are subject to change, which would affect the Company's anticipated contribution. In addition, subject to conditions at the time of any contribution, the Company may elect to contribute more or less than its proportionate share.

*Hallwood Energy Corporation.* The Company owned approximately 28% (22% after consideration of stock options) of HEC. It accounted for the investment using the equity method of accounting and recorded its pro rata share of HEC's net income (loss) and stockholders' equity transactions. The Company invested \$3,500,000 in HEC during 2002, \$1,997,000 in 2003, and \$566,000 in 2004.

In December 2004, HEC completed a merger and sale with Chesapeake Energy Corporation (Chesapeake), under which Chesapeake acquired HEC. In exchange for its interest in HEC, the Company received a cash payment of \$53,793,000 in December 2004, an additional amount of \$387,000 in April 2005 from the settlement of HEC's working capital. The Company also received its proportionate share of the HE III debt in the amount of \$1,995,000, which it contributed to HE III as an additional capital contribution and its proportionate interest in Hallwood SWD, Inc., the former HEC subsidiary that owned the Worthington saltwater disposal well, with a carrying value of approximately \$1,250,000, which it contributed to HE III as an additional capital contribution.

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

In 2004, the Company invested \$4,705,000 in HE III. In March 2005, the Company invested an additional \$4,251,000. In June 2004, HE III acquired from HEC approximately 15,000 net acres of undeveloped leasehold, three proven developed non-producing natural gas properties, a limited amount of gas transmission line and various other assets. During July 2004, HE III entered into an agreement with Chesapeake, which owned approximately 12,000 net acres contiguous to that of HE III, wherein it assigned a 44% interest in its lease holdings to Chesapeake, which in turn assigned a 56% interest in its lease holdings to HE III. Under the joint operating agreement between the two entities, HE III had been designated as operator.

In December 2004, in connection with the sale of HEC, the Company, as a shareholder in HEC, received its proportionate share of debt from HE III owed to HEC in the amount of \$1,995,000, which it contributed to HE III as

an additional capital investment. In addition, the Company received its proportionate share of HEC's investment in its Hallwood SWD, Inc. subsidiary, with a carrying value of approximately \$1,250,000, which was also contributed to HE III as an additional capital investment.

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

In exchange for its interest in HE III, the Company received a cash payment of \$54,850,000 in July 2005 and received an additional \$799,000 in November 2005 from the final working capital adjustment. In addition, the Company received a distribution for its proportionate share of certain pipe inventory owned by HE III, with a proportionate carrying value of approximately \$889,000, which was contributed to HE II as an additional capital investment. The Company also recorded a receivable at December 31, 2005 in the amount of \$470,000 for the settlement of a working capital adjustment with Hallwood Petroleum. The receivable will be contributed to Hallwood Energy in 2006 as an additional capital investment.

*Hallwood Energy II, L.P.* At December 31, 2005, prior to the energy consolidation, the Company owned approximately 24% (20% after consideration of profit interests) of HE II. In September 2004, the Company invested \$2,430,000 in HE II, which was formed to explore various oil and gas exploration opportunities, primarily in Texas, and in areas not associated with HEC and HE III. In calendar year 2005, the Company invested an additional \$10,691,000.

In connection with the July 2005 disposition of HE III, the Company received a deemed distribution of its proportionate share of certain pipe inventory owned by HE III, with a proportionate carrying value of approximately \$889,000, which was then deemed contributed to HE II as an additional capital investment. In July 2005, HE II sold all of its 835 net acres lease holdings in Johnson County, Texas to Chesapeake for \$3,000,000.

*Hallwood Exploration, L.P.* At December 31, 2005, prior to the energy consolidation, the Company investment was approximately 20% (17% after consideration of profit interests) of Hallwood Exploration. In 2004, the Company invested \$1,318,000 in Hallwood Exploration. In calendar year 2005, the Company invested an additional \$3,244,000.

*Hallwood Energy 4, L.P.* HE 4 was formed in the 2005 third quarter. In September and December 2005, the Company invested \$9,193,000 and \$13,130,000 in HE 4, respectively. As of December 31, 2005, prior to the energy consolidation, the Company had a 26% (21% after consideration of profit interests) limited partner interest in HE 4.

*Hallwood Energy, L.P.* Following the completion of the energy consolidation on December 31, 2005, all energy activities are conducted by Hallwood Energy. The company investment is approximately 26% (22% after consideration of profit interests) of Hallwood Energy. Hallwood Energy's management has classified its energy investments into four identifiable areas: Delaware Basin, Texas; Fort Worth Basin, Texas; South Louisiana and East Arkansas.

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

In February 2006, Hallwood Energy entered into a \$65,000,000 loan facility, and has drawn \$40,000,000 as of March 1, 2006, principally to acquire oil and gas leases and fund exploration and drilling activities. It is anticipated that the facility will be fully drawn by June 2006. The loan facility matures in three years and bears interest at a variable rate of Libor + 8.75%.

Hallwood Energy currently anticipates making a request for additional capital contributions in the amount of \$50,000,000 from its partners during 2006. The Company's share of the additional contributions would be approximately \$13,200,000.

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A description of activities in each area is provided below:

***Delaware Basin, Texas***

The primary objective formations are the Barnett Shale, which appears to range in depth from 12,300 to 16,500 feet and to have a thickness of 800 to 1,000 feet; and the Woodford Shale, which appears to range in depth from 13,100 to 17,500 feet and to have a thickness of 200 to 600 feet, both in Reeves and Culberson counties.

Hallwood Energy commenced drilling activities in the 2006 first quarter. Hallwood Energy has three drilling rigs under contract for at least one year, of which two rigs will be used in the Delaware Basin and one rig will be used in the Fort Worth Basin. Hallwood Energy anticipates that it will drill four test wells to depths from 12,300 to 16,500 in Reeves and Culberson counties. Thereafter, drilling and development plans will be determined based on the results of these initial wells.

***Fort Worth Basin, Texas***

Hallwood Energy has leased one drilling rig for this field in Parker and Tarrant counties. The primary objective formation is the Barnett Shale, which appears to have a range in depth from 5,000 to 7,000 feet and to have a thickness of 200 to 400 feet. Drilling activities commenced in the 2005 fourth quarter. The first well was completed and production commenced in January 2006. A second well was drilled prior to March 1, 2006 and two additional test wells are anticipated to be drilled to depths from 4,500 to 6,500 feet in the 2006 first and second quarter. Thereafter, drilling and development plans will be determined based on the results of these initial wells.

***South Louisiana***

Hallwood Energy holds options to acquire leases over approximately 36,000 acres to exploit a salt dome oil and gas opportunity in St. James, Ascension and Assumption parishes. Based on the results of the 3-D seismic data that have been analyzed, approximately 4,000 to 8,000 acres are expected to be retained for future development. Hallwood Energy is actively seeking a rig for a multiple well drilling program, which will include both flank prospects and adjacent structure prospects. Subject to equipment and personnel availability, Hallwood Energy anticipates drilling six prospects during 2006, of which three are shallower crestal wells expected to be drilled beginning in the third quarter. Thereafter, drilling and development plans will be determined based on the results of these initial wells.

***East Arkansas***

The primary objective formation is the Fayetteville Shale, which appears to range in depth from approximately 2,700 to 7,400 feet and to have a thickness of 300 to 700 feet.

Hallwood Energy commenced drilling activities in the 2006 first quarter with one rig under contract. In the first and second quarters of 2006, it anticipates drilling eleven test wells to depths up to 6,000 to 7,000 feet and to have three rigs operating by December 2006. Thereafter, drilling and development plans will be determined based on the results of these initial wells. Hallwood Energy is currently negotiating for access to drilling rigs for these wells. Its ability to adhere to this schedule will depend to a significant extent on the availability of drilling rigs and other services. Because of the significant industry interest in this area, rigs and services are in extremely high demand.

*Hallwood Petroleum, LLC.* The Company's HPL subsidiary commenced operation in October 2004 as an administrative and management company to facilitate record keeping and processing for the energy affiliates and has no financial value. All revenues were credited to, and all costs were borne by, the other energy affiliates with no profit element. All assets nominally in the name of HPL were held solely for the benefit of the other energy affiliates. HPL was formed as a subsidiary of the Company as a convenience and it was not intended that it have any financial impact on the Company. In the 2005 second quarter, the Company determined that its ownership of this pass-through entity created unnecessary complexity, therefore HPL was

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transferred for nominal consideration to officers of the energy affiliates that are not officers of the Company. The transfer was completed on May 11, 2005. Ownership of HPL was acquired for nominal consideration by Hallwood Energy in connection with the December 31, 2005 consolidation.

**Liquidity and Capital Resources**

*General.* The Company's cash position decreased by \$54,901,000 during 2005 to \$16,648,000 as of December 31, 2005. The principal sources of cash in 2005 were \$55,648,000 from the sale of HE III and \$2,207,000 from the exercise of stock options. The principal uses of cash in 2005 were \$66,113,000 for cash dividends, \$2,324,000 for repayment of bank borrowings and other loans, \$40,556,000 for investments in energy affiliates, \$2,726,000 for investments in property, plant and equipment and \$1,483,000 used in operations.

*Textiles.* The Company's textile products segment generates funds from the dyeing, laminating and finishing of fabrics and their sales to customers in the consumer, industrial, medical and military markets. Brookwood maintains a \$22,000,000 revolving line of credit facility and a \$3,000,000 equipment facility with Key Bank. The facilities had a maturity of January 2007. At December 31, 2005, Brookwood had \$16,000,000 of unused borrowing capacity on its revolving line of credit facility and \$2,188,000 on its equipment credit facility. In the years ended December 31, 2005, 2004 and 2003, Brookwood made payments to the Company of \$4,552,000, \$5,373,000 and \$1,987,000, respectively, under its tax sharing agreement. In addition, Brookwood paid cash dividends of \$8,000,000, \$3,000,000 and \$600,000 in 2005, 2004 and 2003, respectively. In March 2006, Brookwood made tax sharing and dividend payments of \$98,000 and \$2,000,000, respectively. Future cash dividends and tax sharing payments are contingent upon Brookwood's continued profitability and compliance with its loan covenants. Brookwood was in compliance with its loan covenants as of December 31, 2005 and for all interim periods in 2005. There were no significant additional capital requirements as of December 31, 2005.

The Key Bank facilities, which had a maturity of January 2007, were renewed in March 2006 for a period of three years with a new maturity date of January 30, 2010. The facility amounts were unchanged, however the interest rate on the revolving line of credit facility was reduced.

*Energy.* Since December 31, 2004, the Company has invested a total of \$43,230,000 in its various energy affiliates, including \$2,721,000 that was paid in January 2006. Hallwood Energy anticipates that substantial additional debt or equity funding will be required over the next few years to complete budgeted property acquisition, exploration and development activities. In February 2006, Hallwood Energy entered into a \$65,000,000 loan facility, and has drawn \$40,000,000 as of March 1, 2006. It is anticipated that the facility will be fully drawn by June 2006. In addition, Hallwood Energy currently anticipates making a request for additional capital contributions in the amount of \$50,000,000 from its partners during 2006. If this request is made in this amount, then the Company will be required to fund approximately \$13,200,000 to maintain its proportionate interest in Hallwood Energy. The Company believes that a contribution in this amount can be made from existing cash and cash flow from operations.

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



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*Future liquidity.* The Company's ability to generate cash flow from operations will depend on its future performance and its ability to successfully implement business and growth strategies. The Company's performance will also be affected by prevailing economic conditions. Many of these factors are beyond the Company's control. Considering its current cash position and its anticipated cash flow from continuing operations, the Company believes it has sufficient funds to meet its liquidity needs, although future capital requirements by Hallwood Energy may impact its liquidity.

**Financial Covenants**

The principal ratios, required to be maintained under Brookwood's Key Working Capital Revolving Credit Facility as of December 31, 2005 and the end of the interim quarters are provided below:

Description	Requirement	Quarters Ended in 2005			
		December 31,	September 30,	June 30,	March 31,
Total debt to tangible net worth	must be less than 1.50	0.65	0.69	0.83	0.97
Net income	must exceed \$1	Yes	Yes	Yes	Yes

Brookwood was in compliance with its loan covenants under the Key Working Capital Revolving Credit Facility as of December 31, 2005 and for all interim periods during 2005.

**Contractual Obligations and Commercial Commitments**

The Company and its subsidiaries have entered into various contractual obligations and commercial commitments in the ordinary course of conducting its business operations, which are provided below as of December 31, 2005 (in thousands):

	Payments Due During the Years Ending December 31,						
	2006	2007	2008	2009	2010	Thereafter	Total
<b>Contractual Obligations</b>							
Long term debt	\$ 352	\$ 280	\$ 152	\$ 28	\$ 6,000		\$ 6,812
Operating leases	942	510	483	195	195		2,325
Total	\$ 1,294	\$ 790	\$ 635	\$ 223	\$ 6,195		\$ 9,137

Interest costs associated with the Company's debt, which principally bears interest at variable rates, are not a material component of the Company's expenses. Estimated interest payments, based on the current principal balances and weighted average interest rates, assuming the contractual repayment of the term loan debt at their maturity dates and a renewal of the revolving credit facilities at their loan balances as of December 31, 2005, are \$422,000, \$399,000, \$385,000, \$377,000 and \$376,000, for the years ending December 31, 2006 through December 31, 2010, respectively.

**Amount of Commitment Expiration  
During the Years Ending December 31,**

	2006	2007	2008	2009	2010	Thereafter	Total
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**Commercial Commitments**

Employment contracts	\$ 50	\$ 50
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As further discussed in Note 5 to the accompanying consolidated financial statements, the Company adopted The Hallwood Group Incorporated 2005 Long-Term Incentive Plan for Brookwood Companies Incorporated ( 2005 Long-Term Incentive Plan for Brookwood ) to attract, retain and motivate key personnel of Brookwood. The terms of the incentive plan provide for a total award amount to participants equal to 15% of the fair market value of consideration received by the Company in a change of control transaction, as defined, in excess of the sum of the liquidation preference plus accrued unpaid dividends on the Brookwood preferred stock (approximately \$28,308,000 at December 31, 2005). Provided certain circumstances are met, the minimum total award amount shall be \$2,000,000. In addition, if certain members of Brookwood senior management do not have at least a two percent equity or debt interest in the entity with

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which the change of control transaction is completed, then the Company will be obligated to pay an additional \$2,600,000.

**Special Purpose Entities**

The Company has, in certain situations, created Special Purpose Entities ( SPE ). These SPEs were formed to hold title to specific assets and accomplish various objectives. In 1998, the Company formed several SPEs to complete a consolidation of its real estate assets into a new structure to facilitate possible financing opportunities. In other situations, SPEs were formed at the request of lenders for the express purpose of strengthening the collateral for the loans by isolating (for Federal bankruptcy law purposes) the assets and liabilities of the SPE s. In all cases and since their various formation dates, these wholly owned entities (including their assets, liabilities and results of operations) have been fully consolidated into the financial statements of the Company.

**New Accounting Pronouncements**

In March 2005, the FASB issued Financial Accounting Standards Board Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* ( FIN 47 ). FIN 47 addresses the recording and reporting of asset retirement obligations, if removal of materials such as asbestos insulation, lead paint PCBs, or other materials covered by environmental regulations, is required. The adoption of FIN 47 did not have any significant effect on the Company s consolidated financial statements.

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets*, an amendment of APB No. 29. This Statement amends Opinion 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. The Statement specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. This Statement is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. Earlier application is permitted for nonmonetary asset exchanges occurring in fiscal periods beginning after the date this Statement is issued. Retroactive application is not permitted. The adoption of SFAS No. 153 on January 1, 2006 did not have any significant impact on the Company s consolidated financial statements.

In December 2004, the FASB issued Statement of Financial Accounting Standards ( SFAS ) No. 123(R), *Share-Based Payments*, which establishes accounting standards for all transactions in which an entity exchanges its equity instruments for goods and services. SFAS No. 123(R) focuses primarily on accounting for transactions with employees, and carries forward without change prior guidance for share-based payments for transactions with non employees. The Company adopted SFAS No. 123(R) effective January 1, 2006. There were no unvested options or options available for grant under the 1995 Stock Option Plan, which expired on June 27, 2005. Accordingly, the adoption of SFAS No. 123(R) did not have any significant impact on the Company s consolidated financial statements.

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs* an amendment of ARB No. 43, Chapter 4, which amends Chapter 4 of ARB No. 43 that deals with inventory pricing. The Statement clarifies the accounting for abnormal amounts of idle facility expenses, freight, handling costs and spoilage. Under previous guidance, paragraph 5 of ARB No. 43, Chapter 4, items such as idle facility expense, excessive spoilage, double freight and re-handling costs might be considered to be so abnormal, under certain circumstances, as to require treatment as current period charges. This Statement eliminates the criterion of so abnormal and requires that those items be recognized as current period charges. Also, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. This Statement is effective for inventory costs incurred during fiscal years beginning after June 15, 2005, although earlier application is permitted for fiscal years beginning after the date of issuance of this Statement. Retroactive application is not permitted. The adoption of SFAS No. 151 on January 1, 2006 did not have any significant impact on the Company s consolidated financial statements.

**Table of Contents****Inflation**

Inflation did not have a significant impact on the Company in the three years ended December 31, 2005, and is not anticipated to have a material impact in 2006.

**Item 7A. *Quantitative and Qualitative Disclosures about Market Risk***

The Company has no foreign operations, and it does not enter into financial instrument transactions for trading or other speculative purposes.

The Company is exposed to market risk due to fluctuations in interest rates. The Company utilizes both fixed and variable rate debt to finance its operations. The table below presents principal cash flows and related weighted average interest rates of the Company's fixed rate and variable rate debt at December 31, 2005 (in thousands):

Debt Classification	Expected Maturities as of Years Ending December 31,						Fair Value
	2006	2007	2008	2009	2010	Total	
Fixed Rate	\$ 67	\$ 70	\$ 55	\$	\$	\$ 192	\$ 188
Average Interest Rate	5.60%	5.60%	5.60%				
Variable Rate	\$ 285	\$ 210	\$ 97	\$ 28	\$ 6,000	\$ 6,620	\$ 6,649
Average Interest Rate	6.38%	6.33%	6.29%	6.27%	6.27%		

There is inherent rollover risk for borrowings as they mature and are renewed at current market rates. The extent of this risk is not quantifiable or predictable because of the variability of future interest rates and the Company's future financing requirements. A hypothetical increase in interest rates of one percentage point would cause a loss in income and cash flows of approximately \$66,000 during 2006, assuming that outstanding debt remained at current levels.

**Forward-Looking Statements**

In the interest of providing stockholders with certain information regarding the Company's future plans and operations, certain statements set forth in this Form 10-K relate to management's future plans, objectives and expectations. Such statements are forward-looking statements. Although any forward-looking statement expressed by or on behalf of the Company is, to the knowledge and in the judgment of the officers and directors, expected to prove true and come to pass, management is not able to predict the future with absolute certainty. Forward-looking statements involve known and unknown risks and uncertainties, which may cause the Company's actual performance and financial results in future periods to differ materially from any projection, estimate or forecasted result. Among others, these risks and uncertainties include those described in Item 1. Business Competition, Risks and Other Factors. These risks and uncertainties are difficult or impossible to predict accurately and many are beyond the control of the Company. Other risks and uncertainties may be described, from time to time, in the Company's periodic reports and filings with the Securities and Exchange Commission.

**Item 8. *Financial Statements and Supplementary Data***

The Company's consolidated financial statements, together with the report of independent registered public accounting firm are included elsewhere herein. Reference is made to Item 15. Financial Statements, Financial Statement Schedules and Exhibits.

**Item 9. *Changes in and Disagreements with Accountants on Accounting and Financial Disclosure***

None.

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**Item 9A. Controls and Procedures**

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

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

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

**Item 9B. Other Information**

None.

**Table of Contents****PART III****Item 10. Directors and Executive Officers of the Registrant**

Certain of the information required by this Item 10 is contained in the definitive proxy statement of the Company for its Annual Meeting of Stockholders ( the Proxy Statement ) under the heading Election of Directors , and such information is incorporated herein by reference. The Proxy Statement will be filed with the Securities and Exchange Commission not later than 120 days after December 31, 2005. Additional information concerning the executive officers of the Company is included under Item 1. Business Executive Officers of the Company .

**Item 11. Executive Compensation**

Information with respect to executive compensation is contained in the Proxy Statement under the headings Executive Compensation , Compensation of Directors and Certain Relationships and Related Transactions , and such information is incorporated herein by reference.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

The following table provides information as of December 31, 2005 about the Company 's Common Stock that may be issued upon the exercise of options granted pursuant to the 1995 Stock Option Plan, as amended:

**Equity Compensation Plan Information**

<b>Plan Category</b>	<b>Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights(1)</b>	<b>Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights</b>	<b>Number of Securities Available for Future Issuance Under Equity Compensation Plans, Excluding Securities Reflected in First Column(2)</b>
Equity compensation plans approved by stockholders	19,125	\$ 15.10	
Equity compensation plans not approved by stockholders			
<b>Total</b>	<b>19,125</b>	<b>\$ 15.10</b>	

(1) The number of shares is subject to adjustment for changes resulting from stock dividends, stock splits, recapitalizations and similar events. The Board of Directors in its discretion may make adjustments, as appropriate, in connection with any transaction.

(2) The 1995 Stock Option Plan terminated on June 27, 2005. Options issued prior to the termination are not affected; however, no new options can be issued.

Information regarding ownership of certain of the Company 's outstanding securities is contained in the Proxy Statement under the heading Security Ownership of Certain Beneficial Owners and Management , and such information is incorporated herein by reference. Information regarding equity compensation plans are contained in the Proxy Statement under the heading Executive Compensation .

**Item 13. Certain Relationships and Related Transactions**

Information regarding certain relationships and related transactions is contained in the Proxy Statement under the headings Compensation Committee Interlocks and Insider Participation and Certain Relationships and Related Transactions , and such information is incorporated herein by reference.

**Item 14. *Principal Accounting Fees and Services***

Information concerning principal auditor fees and services is contained in the Proxy Statement under the heading Audit Fees and Pre-Approval Policy and such information is incorporated herein by reference.

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**PART IV**

**Item 15. *Financial Statements, Financial Statement Schedules and Exhibits***

Reference is made to the Index to Financial Statements and Schedules appearing after the signature page hereof.

1. *Financial Statements.*

Included in Part II, Item 8. of this report are the following  
Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets, December 31, 2005 and 2004

Consolidated Statements of Operations, Years ended December 31, 2005, 2004 and 2003

Consolidated Statements of Comprehensive Income, Years ended December 31, 2005, 2004 and 2003

Consolidated Statements of Changes in Stockholders' Equity, Years ended December 31, 2003, 2004 and 2005

Consolidated Statements of Cash Flows, Years ended December 31, 2005, 2004 and 2003

Notes to Consolidated Financial Statements

2. *Financial Statement Schedules.*

Independent Registered Public Accounting Firm's Report on Schedules

I. Condensed Financial Information of Registrant

II. Valuation and Qualifying Accounts and Reserves

All other schedules are omitted since the required information is not applicable or is included in the consolidated financial statements or related notes.

Financial Statements of Hallwood Energy, L.P. and Subsidiaries

Consolidated Financial Statements for the Years Ended December 31, 2005 and 2004 (Unaudited) and Report of Independent Registered Public Accounting Firm

3. *Exhibits.*

(a) *Exhibits.*

- |       |  |
|-------|--|
| 3.1   | Second Restated Certificate of Incorporation of The Hallwood Group Incorporated, is incorporated herein by reference to Exhibit 4.2 to the Company's Form S-8 Registration Statement, filed on October 26, 1995 File No. 33-63709.   |
| 3.2   | Amendment to Second Restated Certificate of Incorporation of The Hallwood Group Incorporated, is incorporated herein by reference to Exhibit 2.2 to the Company's Form 8-K filed on May 14, 2004, File No. 1-8303.                   |
| 3.3   | Restated Bylaws of the Company is incorporated herein by reference to Exhibit 3.2 to the Company's Form 10-K for the year ended December 31, 1997, File No. 1-8303.  |
| *10.1 | Employment Agreement, dated January 1, 1994, between the Company and Melvin John Melle, as incorporated by reference to Exhibit 10.9 to the Company's Form 10-K for the fiscal year ended July 31, 1994, File No. 1-8303.            |
| 10.2  | Tax Sharing Agreement, dated as of March 15, 1989, between the Company and Brookwood Companies Incorporated is incorporated herein by reference to Exhibit 10.25 to the Company's Form 10-K for the fiscal year ended July 31, 1989, |



\*10.3 File No. 1-8303.  
Amended Tax-Favored Savings Plan Agreement of the Company, effective as of February 1, 1992, is incorporated herein by reference to Exhibit 10.33 to the Company's Form 10-K for the fiscal year ended July 31, 1992, File No. 1-8303.

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- \*10.4 Hallwood Special Bonus Agreement, dated as of August 1, 1993, between the Company and all members of its control group that now, or hereafter, participate in the Hallwood Tax Favored Savings Plan and its related trust, and those employees who, during the plan year of reference are highly- compensated employees of the Company, is incorporated herein by reference to Exhibit 10.34 to the Company's Form 10-K for the fiscal year ended July 31, 1994, File No. 1-8303.
- \*10.5 Financial Consulting Agreement, dated as of December 31, 1996, between the Company and Hallwood Investments Limited, formerly HSC Financial Corporation, is incorporated herein by reference to Exhibit 10.22 to the Company's Form 10-K for the year ended December 31, 1996, File No. 1-8303.
- \*10.6 Amendment to Financial Consulting Agreement, dated as of May 16, 2001, between the Company and Hallwood Investments Limited is incorporated herein by reference to Exhibit 10.9 to the Company's Form 10-K for the year ended December 31, 2001, File No. 1-8303.
- \*10.7 Amendment to Financial Consulting Agreement, dated as of January 1, 2000, between the Company and Hallwood Investments Limited, is incorporated herein by reference to Exhibit 10.15 to the Company's Form 10-Q for the quarter ended March 31, 2000, File No. 1-8303.
- 10.8 Promissory Note and Security Agreement regarding equipment term loan in the amount of \$1,000,000.00, dated as of September 29, 2000, between Brookwood Companies Incorporated, Kenyon Industries, Inc., Brookwood Laminating, Inc., Ashford Bromely, Inc., Xtramile, Inc., and Land Ocean III, Inc. and Key Leasing, a division of Key Corporate Capital, Inc., fixed interest 9.37%, due September 29, 2005, is incorporated herein by reference to exhibit 10.19 to the Company's Form 10-Q for the quarter ended March 31, 2002, File No. 1-8303.
- 10.9 Promissory Note and Security Agreement regarding equipment term loan in the amount of \$541,976.24, dated as of February 25, 2002, between Brookwood Companies Incorporated, Kenyon Industries, Inc., Brookwood Laminating, Inc., Ashford Bromely, Inc., Xtramile, Inc., and Land Ocean III, Inc. and Key Leasing, a division of Key Corporate Capital, Inc., Libor plus 325 basis points-floating, due February 25, 2007, is incorporated herein by reference to exhibit 10.20 to the Company's Form 10-Q for the quarter ended March 31, 2002, File No. 1-8303.
- 10.10 Promissory Note and Security Agreement regarding equipment term loan in the amount of \$298,018, dated as of December 20, 2002, between Brookwood Companies Incorporated, Kenyon Industries, Inc., Brookwood Laminating, Inc., Ashford Bromely, Inc., Xtramile, Inc., Land Ocean III, Inc. and Strategic Technical Alliance LLC and Key Leasing, a division of Key Corporate Capital, Inc., fixed interest 4.67%, due December 20, 2007, is incorporated herein by reference to Exhibit 10.16 to the Company's Form 10-K for the year ended December 31, 2002, File No. 1-8303.
- 10.11 Second Amended and Restated Revolving Credit Loan and Security Agreement, dated as of January 30, 2004, by and among Key Bank National Association, Brookwood Companies Incorporated and certain subsidiaries, is incorporated by reference to Exhibit 10.21 to the Company's Form 10-K for the year ended December 31, 2003, File No. 1-8303.
- \*10.12 Amendment to Financial Consulting Agreement, dated March 10, 2004, by and between the Company and Hallwood Investments Limited, is incorporated by reference to Exhibit 10.22 to the Company's Form 10-K for the year ended

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- December 31, 2003, File No. 1-8303.
- \*10.13 Compensation Letter, dated May 11, 1998, between Brookwood Companies Incorporated and Amber M. Brookman is incorporated by reference to Exhibit 10.24 to the Company's Form 10-Q for the quarter ended March 31, 2004, File No. 1-8303.
- \*10.14 Amended 1995 Stock Option Plan for The Hallwood Group Incorporated is incorporated by reference to Annex B of the Company's Proxy Statement, as filed on April 18, 2001, File No. 1-8303.
- \*10.15 Form of Stock Option Agreement to 1995 Stock Option Plan for The Hallwood Group Incorporated, is incorporated herein by reference to Exhibit 10.16 to the Company's Form 10-K for the year ended December 31, 2004, File No. 1-8303.
- \*10.16 Amendment to Financial Consulting Agreement, dated March 9, 2005, by and between the Company and Hallwood Investments Limited, is incorporated herein by reference to Exhibit 10.16 to the Company's Form 10-K for the year ended December 31, 2004, File No. 1-8303.

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*10.17	Brookwood Companies Incorporated Stock Option Plan, dated June 12, 1989, as amended April 5, 1993 and May 3, 1999, is incorporated herein by reference to Exhibit 10.16 to the Company's Form 10-K for the year ended December 31, 2004, File No. 1-8303.
*10.18	Form of Stock Option Agreement to The Brookwood Companies Incorporated Stock Option Plan, is incorporated herein by reference to Exhibit 10.16 to the Company's Form 10-K for the year ended December 31, 2004, File No. 1-8303.
10.19	First Amendment to Second Amended and Restated Revolving Credit Loan and Security Agreement, dated as of March 25, 2005, by and among Key Bank National Association, Brookwood Companies Incorporated and certain subsidiaries, is incorporated by reference to Exhibit 10.20 to the Company's Form 10-Q for the quarter ended March 31, 2005, File No. 1-8303.
*10.20	The Hallwood Group Incorporated 2005 Long-Term Incentive Plan for Brookwood Companies Incorporated and Unit Agreement under the Plan between Amber M. Brookman and the Company, is incorporated herein by reference to Exhibits 99.1 and 99.2 to the Company's Form 8-K dated January 17, 2006, File No. 1-8303.
10.21	Limited Partnership Agreement of Hallwood Energy 4, L.P., a Delaware Limited Partnership, dated as of August 23, 2005; Memorandum of Amendment Changing the Name of Hallwood Energy 4, L.P. to Hallwood Energy, L.P., effective immediately before midnight on December 31, 2005; and Amendment to Limited Partnership Agreement of Hallwood Energy, L.P. dated as of December 31, 2005, <i>filed herewith.</i>
10.22	Second Amendment to Second Amended and Restated Revolving Credit Loan and Security Agreement, dated as of March 25, 2006, by and among Key Bank National Association, Brookwood Companies Incorporated and certain subsidiaries, <i>filed herewith.</i>
21	Active subsidiaries of the Registrant as of February 28, 2006, <i>filed herewith.</i>
23.1	Independent Registered Public Accounting Firm's Consent, dated April 11, 2006, <i>filed herewith.</i>
31.1	Certification of the Chief Executive Officer, pursuant to Section 302 of Sarbanes-Oxley Act of 2002, <i>filed herewith.</i>
31.2	Certification of the Chief Financial Officer, pursuant to Section 302 of Sarbanes-Oxley Act of 2002, <i>filed herewith.</i>
32.1	Certification of the Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, <i>filed herewith.</i>

\* Constitutes a compensation plan or agreement for executive officers.

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

By: THE HALLWOOD GROUP INCORPORATED  
/s/ Melvin J. Melle

Melvin J. Melle  
*Vice President Finance*  
*(Principal Financial and Accounting Officer)*

Dated: April 11, 2006

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant on the 11<sup>th</sup> day of April 2006.

<u>/s/ Melvin J. Melle</u> (Melvin J. Melle)	Vice President Finance (Principal Financial and Accounting Officer)
<u>/s/ Anthony J. Gumbiner</u> (Anthony J. Gumbiner)	Director and Chairman of the Board (Principal Executive Officer)
<u>/s/ Charles A. Crocco, Jr.</u> (Charles A. Crocco, Jr.)	Director
<u>/s/ A. Peter Landolfo</u> (A. Peter Landolfo)	Director
<u>/s/ M. Garrett Smith</u> (M. Garrett Smith)	Director
<u>/s/ J. Thomas Talbot</u> (J. Thomas Talbot)	Director

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Stockholders and Directors of  
The Hallwood Group Incorporated

We have audited the accompanying consolidated balance sheets of The Hallwood Group Incorporated and subsidiaries (the Company) as of December 31, 2005 and 2004, and the related consolidated statements of operations, comprehensive income, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of The Hallwood Group Incorporated and subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP  
Dallas, Texas  
April 11, 2006

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
(Dollars in thousands, except per share amounts)

	December 31,	
	2005	2004
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 16,648	\$ 71,549
Accounts receivable		
Trade and other	18,987	25,340
Related parties	616	165
Inventories	16,879	23,581
Prepaid income taxes	1,322	
Deferred income tax	1,029	2,213
Prepays, deposits and other assets	831	1,314
Marketable securities trading		6,100
Restricted cash related parties		218
	56,312	130,480
<b>Noncurrent Assets</b>		
Investments in energy affiliates	40,854	12,491
Property, plant and equipment, net	11,358	11,070
Other assets	277	503
Deferred income tax		2,444
	52,489	26,508
<b>Discontinued Operations</b>		
Real estate		329
<b>Total Assets</b>	<b>\$ 108,801</b>	<b>\$ 157,317</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 7,274	\$ 15,095
Accrued expenses and other current liabilities	4,848	5,722
Current portion of loans payable	352	347
Income taxes payable	9	1,167
Related party payables		490
	12,483	22,821
<b>Noncurrent Liabilities</b>		
Long term portion of loans payable	6,460	8,789
Redeemable preferred stock	1,000	1,000
Deferred income tax	415	



	7,875	9,789
<b>Discontinued Operations</b>		
Real estate		166
<b>Total Liabilities</b>	20,358	32,776
<b>Contingencies and Commitments</b>		
<b>Stockholders Equity</b>		
Common stock, \$0.10 par value; authorized 10,000,000 shares; issued 2,396,103 shares at both dates; outstanding 1,511,218 and 1,326,343 shares, respectively	240	240
Additional paid-in capital	56,258	54,792
Retained earnings	45,126	85,443
Treasury stock, 884,885 and 1,069,760 shares, respectively; at cost	(13,181)	(15,934)
<b>Total Stockholders Equity</b>	88,443	124,541
<b>Total Liabilities and Stockholders Equity</b>	\$ 108,801	\$ 157,317

See accompanying notes to consolidated financial statements.

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

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
<b>Revenues</b>			
Textile products sales	\$ 133,108	\$ 136,276	\$ 104,720
Administrative fees from energy affiliates	1,499	1,004	
	134,607	137,280	104,720
<b>Expenses</b>			
Textile products cost of sales	105,299	102,772	83,262
Administrative and selling expenses	29,255	22,837	16,883
	134,554	125,609	100,145
Operating income	53	11,671	4,575
<b>Other Income (Loss)</b>			
Gain (loss) from disposition of investments in energy affiliates			
HE III	52,425		
HEC	(113)	62,288	
Equity income (loss) from investments in energy affiliates	(8,500)	(9,901)	50
Interest and other income (expense)	1,532	1,536	(27)
Interest expense	(545)	(1,197)	(1,636)
Amortization of deferred revenue noncompetition agreement		1,007	2,417
Separation Agreement income		375	
	44,799	54,108	804
Income from continuing operations before income tax	44,852	65,779	5,379
Income tax expense	18,510	11,079	1,725
Income from continuing operations	26,342	54,700	3,654
Income (loss) from discontinued operations, net of tax			
Real estate		39,002	4,339
Hotels		783	(568)
		39,785	3,771
<b>Net Income</b>	<b>26,342</b>	<b>94,485</b>	<b>7,425</b>
Cash dividend on redeemable preferred stock			(50)
<b>Net Income Available to Common Stockholders</b>	<b>\$ 26,342</b>	<b>\$ 94,485</b>	<b>\$ 7,375</b>
<b>Per Common Share</b>			
Basic			

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Income from continuing operations after preferred dividend	\$ 18.22	\$ 41.24	\$ 2.68
Income from discontinued operations		30.00	2.79
Net income available to common stockholders	\$ 18.22	\$ 71.24	\$ 5.47
<b>Assuming Dilution</b>			
Income from continuing operations after preferred dividend	\$ 17.47	\$ 36.79	\$ 2.59
Income from discontinued operations		26.76	2.71
Net income available to common stockholders	\$ 17.47	\$ 63.55	\$ 5.30
<b>Weighted Average Shares Outstanding</b>			
Basic	1,446	1,326	1,347
Assuming Dilution	1,508	1,487	1,390

See accompanying notes to consolidated financial statements.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
(In thousands)

	Years Ended December 31,		
	2005	2004	2003
<b>Net Income</b>	\$ 26,342	\$ 94,485	\$ 7,425
Other Comprehensive Income (Loss)			
Pro rata share of other comprehensive income from equity investments:			
Sale of real estate investments		(105)	
Amortization of interest rate swap		(30)	(56)
		(135)	(56)
<b>Comprehensive Income</b>	\$ 26,342	\$ 94,350	\$ 7,369

See accompanying notes to consolidated financial statements.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY**  
**Years Ended December 31, 2003, 2004 and 2005**  
(Amounts in thousands)

	Common Stock		Additional Paid-In Capital	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income		Treasury Stock		Total Stockholders Equity
	Shares	Par Value			Shares	Cost			
<b>Balance, January 1, 2003</b>	2,396	\$ 240	\$ 54,452	\$ (16,417)	\$ 191	1,035	\$ (15,330)	\$ 23,136	
Net income				7,425				7,425	
Purchase of treasury stock						35	(604)	(604)	
Pro rata share of partners capital transactions from equity investments:									
Exercise of stock options			(22)					(22)	
Amortization of interest rate swap					(56)			(56)	
Cash dividend on preferred stock				(50)				(50)	
<b>Balance, December 31, 2003</b>	2,396	240	54,430	(9,042)	135	1,070	(15,934)	29,829	
Net income				94,485				94,485	
Pro rata share of partners capital transactions from equity investments:									
Sale of real estate investments			362		(105)			257	
Amortization of interest rate swap					(30)			(30)	
<b>Balance, December 31, 2004</b>	2,396	240	54,792	85,443		1,070	(15,934)	124,541	
Net income				26,342				26,342	
Cash dividends on common stock				(66,113)				(66,113)	
Reissuance of treasury shares from exercise of stock options and related income tax effect			1,466	(546)		(185)	2,753	3,673	

<b>Balance, December 31, 2005</b>	2,396	\$	240	\$	56,258	\$	45,126	\$	885	\$	(13,181)	\$	88,443
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See accompanying notes to consolidated financial statements.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In thousands)

	Years Ended December 31,		
	2005	2004	2003
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net income	\$ 26,342	\$ 94,485	\$ 7,425
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Gain from sale of investment in HE III	(52,425)		
Equity (income) loss from investments in energy affiliates	8,500	9,901	(50)
Proceeds from sale of (investments in) marketable securities	6,051	(5,000)	
Depreciation and amortization	1,850	1,870	2,175
Deferred tax expense (benefit)	4,043	(1,094)	822
Gain from sale of investment in HEC	113	(62,288)	
(Income) loss from investments in marketable securities	49	(944)	
Payment to exercise option of Separation Agreement		(3,000)	
Amortization of deferred revenue noncompetition agreement		(1,007)	(2,417)
Gain from extinguishment of Separation Agreement		(375)	
Amortization of deferred gain from debenture exchange		(101)	(56)
Changes in assets and liabilities:			
Increase (decrease) in accounts payable	(7,237)	4,903	1,101
(Increase) decrease in inventories	6,702	(2,359)	(2,337)
(Increase) decrease in accounts receivable	6,372	(6,899)	(2,695)
Increase (decrease) in income taxes payable/receivable	(1,014)		
Increase (decrease) in accrued expenses and other current liabilities	(874)	3,460	1,716
Increase (decrease) in other assets and liabilities	(118)	(1,039)	602
Discontinued operations:			
Net change in other assets and liabilities	163	190	890
Gain from sale of investments in HRP, net		(46,074)	
Deferred tax expense (benefit)		5,143	(5,307)
Equity loss from investments in HRP		2,769	436
Payment of litigation judgment to HRP		(1,877)	
Gain from extinguishment of hotel debt		(1,598)	
Increase in accrued litigation expense to HRP		50	
Net cash provided by (used in) operating activities	(1,483)	(10,884)	2,305
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Proceeds from sale of investment in HE III	55,648		
Proceeds from sale of investment in HEC	387	55,788	
Investment in energy affiliates	(40,556)	(11,032)	(1,997)
Investments in property, plant and equipment, net	(2,726)	(3,361)	(1,561)
Discontinued operations:			
Proceeds from sale of investments in HRP, net of transaction costs	59	59,488	
Investments in hotel		(65)	(13)

Investment in HRP partnership interests			(3,037)
Net cash provided by (used in) investing activities	12,812	100,818	(6,608)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Cash dividends on common stock	(66,113)		
Proceeds from exercise of stock options	2,207		
Proceeds from (repayment of) revolving credit facilities, net	(1,977)	(7,023)	3,500
Repayment of other loans and capital lease obligations	(347)	(14,742)	(2,413)
Proceeds from loans		6,963	5,472
Redemption of 10% Debentures		(6,468)	
Purchase of common stock for treasury			(604)
Deferred loan costs			(94)
Cash dividend on preferred stock			(50)
Net cash provided by (used in) financing activities	(66,230)	(21,270)	5,811
<b>INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	(54,901)	68,664	1,508
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR</b>	71,549	2,885	1,377
<b>CASH AND CASH EQUIVALENTS, END OF YEAR</b>	\$ 16,648	\$ 71,549	\$ 2,885

See accompanying notes to consolidated financial statements.



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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1 Organization and Significant Accounting Policies**

*Continuing Operations.* The Hallwood Group Incorporated ( Hallwood or the Company ) (AMEX:HWG), a Delaware corporation, is a holding company that currently operates in the textile products and energy business segments. The Company's former real estate and hotel business segments have been reported as discontinued operations.

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

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

Effective December 31, 2005, the remaining private energy affiliates, HE II, HE 4 and Hallwood Exploration were consolidated into HE 4, which was renamed Hallwood Energy, L.P. ( Hallwood Energy ). The partners' capital interests in Hallwood Energy were proportionate to the capital invested in each entity at December 31, 2005. The Company's investment in Hallwood Energy at December 31, 2005 was comprised of its capital contributions to each of the former private energy affiliates. The Company owns approximately 26% (22% after consideration of profits interests) of Hallwood Energy.

*Discontinued Operations.* The Company's real estate activities were conducted primarily through the Company's wholly owned subsidiaries. Hallwood Realty, LLC ( Hallwood Realty ) served as the general partner of Hallwood Realty Partners, L.P. ( HRP ), a former publicly traded master limited partnership. Hallwood Commercial Real Estate, LLC ( HCRE ) served as property manager. Revenues were generated from the receipt of management fees, leasing commissions and other fees from HRP and third parties and the Company's 22% pro rata share of earnings of HRP using the equity method of accounting.

In April 2004, HRP announced that it and certain of its affiliates had entered into an Agreement and Plan of Merger (the Agreement and Plan of Merger ) with HRPT Properties Trust ( HRPT ), pursuant to which HRP would merge with a subsidiary of HRPT. The merger and sale were completed in July 2004. As a result, HRP became a wholly-owned subsidiary of HRPT and was no longer a publicly traded limited partnership. The general partner interest in HRP was also sold to a HRPT subsidiary in a separate transaction. The Company no longer holds any interest in HRP. The Company received \$66,119,000 for its interests in HRP.

In December 2000, the Company decided to dispose of its hotel segment, which at that time consisted of five hotel properties. Accordingly, the Company's hotel operations were reclassified as a discontinued operation. Two hotels were disposed of in 2001 and two hotels were disposed of in 2002. The Company continued to operate a leasehold interest in one hotel until December 2004, when the hotel subsidiary entered into a Lease Termination and Mutual Release Agreement with the landlord. In connection with the lease

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

Significant accounting policies, which are in accordance with accounting principles generally accepted in the United States of America, are as follows:

***Principles of Consolidation***

The consolidated financial statements include the accounts of the Company and its continuing and discontinued subsidiaries:

Continuing subsidiaries:

Brookwood Companies Incorporated and subsidiaries  
Brock Suite Hotels, Inc. (inactive)  
HSC Securities Corporation (inactive)

Discontinued subsidiaries:

Brock Suite Greenville, Inc. (until October 2004)  
Brock Suite Huntsville, Inc. (until December 2005)  
Brock Suite Tulsa, Inc. (until October 2004)  
HCRE California, Inc. (until October 2005)  
HWG, LLC (until December 2005)  
HWG 95 Advisors, Inc. (until September 2004)  
HWG 98 Advisors, Inc (until September 2004)  
HWG Holding One, Inc. (until December 2005)  
HWG Holding Two, Inc. (until December 2005)  
HWG Realty Investors, LLC (until October 2004)  
Hallwood Commercial Real Estate, LLC (until October 2005)  
Hallwood Investment Company (until December 2005)  
Hallwood Petroleum, LLC (from October 2004 to May 2005)  
Hallwood Realty, LLC (until October 2005)

The Company fully consolidates all of the above subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

***Recognition of Income***

Textile products sales are recognized upon shipment or release of product, when title passes to the customer. Brookwood provides allowances for expected cash discounts, returns, claims and doubtful accounts based upon historical bad debt and claims experience and periodic evaluation of the aging of accounts receivable. If the financial condition of Brookwood's customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

On occasion, Brookwood receives instructions from some of its customers to finish fabric, invoice the full amount and hold the finished inventory until the customer sends shipping instructions. In those cases, Brookwood records the sale and sends the customer an invoice containing normal and usual payment terms and segregates the inventory from Brookwood's inventory.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Carrying Value of Investments***

Investments are recorded at fair value determined as of the date acquired. Thereafter, for less than 50% owned investments, equity accounting is utilized where the Company exercises significant influence over the investee's operating and financial policies.

***Impairment***

Management reviews its investments for impairment losses when events and circumstances indicate that the carrying amount of an asset may not be recoverable. In the event such indicators exist for assets held for use, and if undiscounted cash flows before interest charges are less than carrying value, the asset is written down to estimated fair value. Assets held for sale are carried at the lower of cost or estimated sales price less costs of sale.

***Depreciation and Amortization***

Depreciation of textile products buildings, equipment and improvements is computed on the straight-line method. Buildings and improvements are depreciated over a period of 15 to 20 years. Equipment is depreciated over a period of 3 to 10 years.

***Income Taxes***

The Company files a consolidated federal income tax return. Deferred tax assets and liabilities are recorded based on the difference between the tax basis of assets and liabilities and their carrying amounts for financial reporting purposes, referred to as temporary differences and the amount of net operating loss carryforwards and tax credits reduced by a valuation allowance as considered appropriate. Provision is made for deferred taxes relating to temporary differences in the recognition of income and expense for financial reporting.

***Inventories***

Inventories are valued at the lower of cost (first-in, first-out or specific identification method) or market.

***Cash and Cash Equivalents***

The Company considers highly liquid investments with original maturities of three months or less at the time of purchase to be cash equivalents.

***Marketable Securities***

Marketable securities are classified as trading and are carried at fair value on the balance sheet. Unrealized gains and losses are included in continuing operations.

***Environmental Remediation Costs***

The Company accrues for losses associated with environmental remediation obligations when such losses are probable and can be reasonably estimated. Accruals for estimated losses from environmental remediation obligations generally are recognized no later than completion of the remedial feasibility study. Such accruals are adjusted as further information develops or circumstances change. Recoveries of environmental remediation costs from other parties are recorded as assets when their receipt is deemed probable. Company management is not aware of any environmental remediation obligations which would significantly affect the operations, financial position or cash flow of the Company.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Stock-Based Compensation***

Statement of Financial Accounting Standards ( SFAS ) No. 123, Accounting for Stock-Based Compensation establishes a method of accounting whereby recognized option pricing models are used to estimate the fair value of stock-based compensation, including options. The Company has elected, as provided by SFAS No. 123, not to recognize employee stock-based compensation expense as calculated under SFAS No. 123, but has recognized such expense in accordance with the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees . As all of the Company 's options were fully vested prior to December 21, 2002, there was no difference between the historical operations and pro forma operations for each of the three years ended December 31, 2005 had the expense provisions of SFAS No. 123 been adopted.

***Research and Development Costs***

Expenditures relating to the development of new products and processes, including significant improvements to existing products, are expensed as incurred. Research and development expenses were approximately \$335,000 in 2005 and were not significant in 2004 and 2003.

***Other Comprehensive Income***

Other comprehensive income items are revenues, expenses, gains and losses that under accounting principles generally accepted in the United States of America are excluded from current period net income and reflected as a component of stockholders ' equity. The Company records a pro rata share of comprehensive income items reported by its investments accounted for using the equity method of accounting.

***Use of Estimates***

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect reported amounts of certain assets, liabilities, revenues and expenses as of and for the reporting periods. Actual results may differ from such estimates.

***Concentration of Credit Risk***

The financial instruments of its wholly owned subsidiaries, which potentially subject the Company to concentration of credit risk, consist principally of accounts receivable. The Company 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. The Company controls its exposure to credit risks through credit approvals, credit limits and monitoring procedures and the use of factors.

***Derivatives***

The Company accounts for derivative instruments in accordance with Statement of Financial Accounting Standards No. 133 Accounting for Derivative Instruments and Hedging Activities ( SFAS No. 133 ). The Company does not directly have any derivative instruments, however HRP did have such instruments. Accordingly, the Company recorded its proportional share of any impact of these instruments in accordance with the equity method of accounting.

HRP had one derivative, an interest rate cap. Since this derivative was designated as a cash flow hedge, changes in the fair value of the derivative were recognized in other comprehensive income until the hedged item was recognized in earnings. Hedge effectiveness was measured based on the relative changes in the fair value between the derivative contract and the hedged item over time. Any changes in fair value resulting from ineffectiveness, as defined by SFAS No. 133, were recognized immediately in current earnings.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Per Common Share Calculations***

Basic income per share was computed by dividing net income available to common stockholders by the weighted average shares outstanding. Income per common share assuming dilution was computed by dividing net income available to common stockholders by the weighted average of shares and potential shares outstanding. Stock options are considered to be potential common shares. The number of potential common shares from assumed exercise of options is computed using the treasury stock method .

***Reclassifications***

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

***New Accounting Pronouncements***

In March 2005, the FASB issued Financial Accounting Standards Board Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations ( FIN 47 ). FIN 47 addresses the recording and reporting of asset retirement obligations, if removal of materials such as asbestos insulation, lead paint PCBs, or other materials covered by environmental regulations, is required. The adoption of FIN 47 did not have any significant effect on the Company's consolidated financial statements.

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets*, an amendment of APB No. 29. This Statement amends Opinion 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. The Statement specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. This Statement is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. Earlier application is permitted for nonmonetary asset exchanges occurring in fiscal periods beginning after the date this Statement is issued. Retroactive application is not permitted. The adoption of SFAS No. 153 on January 1, 2006 did not have any significant impact on the Company's consolidated financial statements.

In December 2004, the FASB issued Statement of Financial Accounting Standards ( SFAS ) No. 123(R), *Share-Based Payments*, which establishes accounting standards for all transactions in which an entity exchanges its equity instruments for goods and services. SFAS No. 123(R) focuses primarily on accounting for transactions with employees, and carries forward without change prior guidance for share-based payments for transactions with non employees. The Company adopted SFAS No. 123(R) effective January 1, 2006. There were no unvested options or options available for grant under the 1995 Stock Option Plan, which expired on June 27, 2005. Accordingly, the adoption of SFAS No. 123(R) did not have any significant impact on the Company's consolidated financial statements.

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs* an amendment of ARB No. 43, Chapter 4, which amends Chapter 4 of ARB No. 43 that deals with inventory pricing. The Statement clarifies the accounting for abnormal amounts of idle facility expenses, freight, handling costs and spoilage. Under previous guidance, paragraph 5 of ARB No. 43, Chapter 4, items such as idle facility expense, excessive spoilage, double freight and re-handling costs might be considered to be so abnormal, under certain circumstances, as to require treatment as current period charges. This Statement eliminates the criterion of so abnormal and requires that those items be recognized as current period charges. Also, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. This Statement is effective for inventory costs incurred during fiscal years beginning after June 15, 2005, although earlier application is permitted for fiscal years beginning after the date

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

of issuance of this Statement. Retroactive application is not permitted. The adoption of SFAS No. 151 on January 1, 2006 did not have any significant impact on the Company's consolidated financial statements.

**Note 2 Cash and Cash Equivalents**

Cash and cash equivalents as of the balance sheet dates were as follows (in thousands):

	<b>December 31,</b>	
	<b>2005</b>	<b>2004</b>
Cash	\$ 395	\$ 457
Cash equivalents	16,253	71,092
<b>Total</b>	<b>\$ 16,648</b>	<b>\$ 71,549</b>

Cash equivalents consisted of secured bank repurchase agreements, money market funds (consisting of AAA rated institutional commercial paper), government securities and interest-bearing demand deposits.

**Note 3 Inventories**

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

	<b>December 31,</b>	
	<b>2005</b>	<b>2004</b>
Raw materials	\$ 6,257	\$ 8,353
Work in progress	5,103	6,883
Finished goods	6,093	9,446
	17,453	24,682
Less: Obsolescence reserve	(574)	(1,101)
<b>Total</b>	<b>\$ 16,879</b>	<b>\$ 23,581</b>

**Note 4 Property, Plant and Equipment**

Property, plant and equipment consists of the following (in thousands):

	<b>December 31,</b>	
	<b>2005</b>	<b>2004</b>
Machinery and equipment	\$ 17,061	\$ 15,743
Buildings and improvements	5,082	4,935
Office furniture and equipment	3,337	4,672
Construction in progress	2,155	1,338
Land	594	391

Leasehold improvements	401	449
	28,630	27,528
Less: Accumulated depreciation	(17,272)	(16,458)
Total	\$ 11,358	\$ 11,070

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 5 Operations of Brookwood Companies Incorporated**

*Receivables.* Brookwood maintains factoring agreements which provide that receivables resulting from credit sales to customers, excluding the U.S. Government, may be sold to the factor, subject to a commission of 0.7% and the factor's prior approval. Commissions paid to factors were approximately \$670,000, \$615,000 and \$479,000 for the years ended December 31, 2005, 2004 and 2003, respectively. Factor receivables were \$14,503,000 and \$19,818,000 at December 31, 2005 and 2004, which were net of an allowance for doubtful accounts of \$102,000 and \$94,000, respectively.

Trade receivables were \$4,204,000 and \$5,352,000 at December 31, 2005 and 2004, which were net of an allowance for doubtful accounts of \$64,000 and \$253,000, respectively.

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

Military sales, including sales to Tennier, have comprised an increasing portion of Brookwood's total sales and a greater share of gross profit. Military sales accounted for \$72,456,000, \$75,899,000 and \$45,997,000 in 2005, 2004 and 2003, respectively, which represented 54%, 56% and 44% of its sales.

*Stockholders' Equity.* The Company is the holder of all of Brookwood's outstanding \$13,500,000 Series A, \$13.50 annual dividend per share, redeemable preferred stock and all of its 10,000,000 outstanding shares of common stock. The preferred stock has a liquidation preference of \$13,500,000 plus accrued but unpaid dividends. At December 31, 2005, cumulative dividends in arrears on the preferred stock amounted to approximately \$14,808,000.

Brookwood has a subsidiary stock option plan. The total number of Brookwood's, \$0.01 par value, shares of common stock that could have been purchased under the Brookwood stock option plan could not exceed 2,500,000 in the aggregate. The exercise price was the fair market value determined by Brookwood's board of directors on the date of the grant. At December 31, 2005 there were 287,500 fully vested options outstanding, all with an exercise price of \$0.10 per share.

*2005 Long-Term Incentive Plan for Brookwood.* On December 16, 2005, the outside directors of the board of directors of the Company approved The Hallwood Group Incorporated 2005 Long-Term Incentive Plan for Brookwood Companies Incorporated (the 2005 Long-Term Incentive Plan for Brookwood) to attract, retain and motivate key personnel of Brookwood. The incentive plan is subject to the approval of the holders of a majority of shares of the Company's common stock present in person or represented by proxy at the annual shareholders' meeting and entitled to vote on the incentive plan, and the board of directors has directed that it be submitted to the stockholders for approval at the annual meeting of stockholders scheduled for May 10, 2006. Pursuant to the incentive plan, the directors of Brookwood and key long-term employees, including officers of Brookwood and its subsidiaries, are eligible to receive awards of units that may result in the payment of cash to the participant upon the occurrence of certain events, including a merger, sale of substantially all of the assets to other than management or a change of control of Brookwood. The Brookwood stock option plan was terminated concurrently with the adoption of the incentive plan and any options held pursuant to the Brookwood stock option plan will be cancelled upon shareholder approval of the 2005 Long-Term Incentive Plan for Brookwood.

The terms of the incentive plan provide for individual awards to eligible participants. In the event of a change of control transaction, as defined, a total award amount would be payable to the participants equal to 15% of the amount by which the net fair market value of all consideration received by the Company as a result of the change of control transaction exceeds the sum of the liquidation preference plus accrued but unpaid



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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

dividends on the Brookwood preferred stock (approximately \$28,308,000 at December 31, 2005). The base amount will fluctuate in accordance with a formula that increases by the amount of the annual dividend on the preferred stock, currently \$1,823,000, and decreases by the amount of the actual dividends paid by Brookwood to the Company. Provided certain circumstances are met, the minimum total award amount shall be \$2,000,000. The incentive plan also provides that, if certain members of senior management do not have, prior to a change of control transaction, in the aggregate an equity or debt interest of at least two percent in the entity with whom the change of control transaction is completed (exclusive of any such interest any such individual receives with respect to his or her employment following the change of control transaction), then the Company will be obligated to pay an additional \$2,600,000.

**Note 6 Investment in Energy Affiliates**

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

**Hallwood Energy, L.P (formerly HE 4)**

Description of Investment	December 31, 2005		Amount at Which Carried at December 31,		Equity Income (Loss) for the Years Ended December 31,		
	Number of Units Held	Cost or Ascribed Value	2005	2004	2005	2004	2003
<b>Hallwood Energy, L.P.</b>							
Limited partner interest	n/a	\$ 40,954	\$ 40,848				
General partner interest	n/a	6	6				
		\$ 40,960	\$ 40,854				

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

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

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

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

In addition, the accumulated equity income (loss) associated with the investments in the remaining affiliates at the consolidation date, in the amount of \$106,000, were transferred to Hallwood Energy.

Following the completion of the energy consolidation on December 31, 2005, all energy activities are conducted by Hallwood Energy. Hallwood Energy's management has classified its energy investments into four identifiable areas: Delaware Basin, Texas; Fort Worth Basin, Texas; South Louisiana and East Arkansas.

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

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table sets forth summarized financial data of Hallwood Energy as of and for the year ended December 31, 2005 (in thousands):

	<b>Amount</b>
<b>Balance Sheet Data</b>	
Oil and gas properties, net	\$ 61,657
Total assets	164,340
Total liabilities	7,858
Partners' capital	156,482
<b>Statement of Operations Data</b>	
Revenues	\$ 357
Gain from sale of undeveloped leasehold	2,751
Net income	626

**Hallwood Energy III, L.P.**

Description of Investment	December 31, 2005		Amount at Which Carried at December 31,		Equity Income (Loss) for the Years Ended December 31,		
	Number of Units Held	Cost or Ascribed Value	2005	2004	2005	2004	2003
<b>Hallwood Energy III, L.P.</b>							
Limited partner interest	n/a		\$8,959		\$(8,628)		\$(223)

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

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

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

In December 2004, in connection with the sale of HEC, the Company, as a shareholder in HEC, received its proportionate share of debt from HE III owed to HEC in the amount of \$1,995,000, which it contributed directly as an additional capital investment. In addition, the Company received its proportionate share of HEC's investment in its

Hallwood SWD, Inc. subsidiary, with a carrying value of approximately \$1,250,000, which was contributed to HE III as an additional capital investment.

In March 2005, an agreement was entered into with a former officer of the energy affiliates, who is not otherwise affiliated with the Company, to purchase the officer's four percent profit interest in the energy affiliates for \$4,000,000, of which \$3,500,000 was ascribed to HE III and \$250,000 each to HE II and

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Hallwood Exploration. The purchase was settled by the energy affiliates on July 1, 2005. The energy affiliates recorded the purchase amount as compensation expense in the 2005 first quarter and the Company recorded its proportionate share, approximately \$1,100,000, through equity accounting.

The Company's proportionate share of HE III's 2005 loss was principally attributable to compensation expense in connection with the settlement of profit interests concurrent with the completion of the merger and sale in July 2005 discussed below.

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

In exchange for its interest in HE III, the Company received a cash payment of \$54,850,000 in July 2005 and received an additional \$799,000 in November 2005 from the final working capital adjustment. In addition, the Company received a distribution for its proportionate share of certain pipe inventory owned by HE III, with a proportionate carrying value of approximately \$889,000, which was contributed to HE II as an additional capital investment. The Company also recorded a receivable at December 31, 2005 in the amount of \$470,000 for the settlement of a working capital adjustment with Hallwood Petroleum. The receivable will be contributed to Hallwood Energy in 2006 as an additional capital investment.

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

**Hallwood Energy II, L.P.**

Description of Investment	As of December 31, 2005		Amount at Which Carried at December 31,		Equity Income (Loss) for the Years Ended December 31,		
	Number of Units Held	Cost or Ascribed Value	2005	2004	2005	2004	2003
<b>Hallwood Energy II, L.P.</b>							
Limited partner interest	n/a		\$2,424	\$417	\$ (6)		

At December 31, 2005, prior to the energy consolidation, the Company owned approximately 24% (20% after consideration of profit interests) of HE II. It accounted for this investment using the equity method of accounting and recorded its pro rata share of HE II's net income (loss) and partner capital transactions. HE II was formed to explore various oil and gas exploration opportunities, primarily in Texas, and in areas not associated with HEC and HE III. In 2004 and 2005, the Company invested \$2,430,000 and \$10,691,000 in HE II, respectively.

In connection with the July 2005 disposition of HE III, the Company received a deemed distribution of its proportionate share of certain pipe inventory owned by HE III, with a proportionate carrying value of approximately \$889,000, which was then deemed contributed to HE II as an additional capital investment. In addition in July 2005, HE II sold all of its 835 net acres lease holdings in Johnson County, Texas to Chesapeake for \$3,000,000. The

Company included its pro rata share of the gain from this transaction in the 2005 third quarter.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
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Certain of the Company's officers and directors were investors in HE II. In addition, as members of management of HE II, one director and officer and one officer of the Company held a profit interest in HE II.

**Hallwood Exploration, L.P.**

Description of Investment	As of December 31, 2005		Amount at Which Carried at December 31,		Equity Income (Loss) for the Years Ended December 31,		
	Number of Units Held	Cost or Ascribed Value	2005	2004	2005	2004	2003
<b>Hallwood Exploration, L.P.</b>							
Limited partner interest	n/a		\$	\$1,090	\$(165)	\$(228)	

At December 31, 2005, prior to the energy consolidation, the Company owned approximately 20% (17% after consideration of profit interests) of Hallwood Exploration. It accounted for this investment using the equity method of accounting and recorded its pro rata share of Hallwood Exploration's net income (loss) and partner capital transactions. Hallwood Exploration was formed to exploit a salt dome oil and gas opportunity in St. James, Ascension and Assumption Parishes in South Louisiana. In 2004 and 2005, the Company invested \$1,318,000 and \$3,244,000 in Hallwood Exploration, respectively.

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

**Hallwood Energy 4, L.P. (renamed Hallwood Energy, L.P.)**

Description of Investment	As of December 31, 2005		Amount at Which Carried at December 31,		Equity Income (Loss) for the Years Ended December 31,		
	Number of Units Held	Cost or Ascribed Value	2005	2004	2005	2004	2003
<b>Hallwood Energy 4, L.P.</b>							
Limited partner interest	n/a				\$(124)		

At December 31, 2005, prior to the energy consolidation, the Company owned approximately 26% (21% after consideration of profit interests) of HE 4. It accounted for this investment using the equity method of accounting and

recorded its pro rata share of HE 4's net income (loss) and partner capital transactions. In the 2005 third quarter, HE 4 was formed to acquire, explore and develop oil and gas acreage in the Fayetteville Shale in East Arkansas. In September 2005 and December 2005, the Company invested \$9,193,000 and \$13,130,000 in HE 4, respectively.

Effective December 31, 2005, in connection with the energy consolidation, the name of this private energy affiliate was changed to Hallwood Energy, L.P.

***Hallwood Energy Corporation***

Description of Investment	Amount at Which Carried at December 31,		Equity Income (Loss) for Years Ended December 31,		
	2005	2004	2005	2004	2003
<b>Hallwood Energy Corporation</b>					
Common stock				\$(9,444)	\$ 50



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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company owned approximately 28% (22% after consideration of stock options) of HEC. It accounted for the investment using the equity method of accounting and recorded its pro rata share of HEC's net income (loss) and stockholder's equity transactions. The Company invested \$6,063,000 in HEC from 2002 until its sale.

The Company's proportionate share of HEC's 2004 loss was principally attributable to compensation expense in connection with the settlement of stock options concurrent with the completion of the merger and sale in December 2004 discussed below.

*Loan Participation Agreement.* In September 2004, the Company entered into a \$6,000,000 *pari passu* Loan Participation Agreement in connection with HEC's \$36,000,000 loan facility. The Company advanced \$2,000,000 to HEC under the Loan Participation Agreement in September 2004 and the remainder of \$4,000,000 in October 2004. The loan was fully repaid in December 2004. The Company earned \$159,000 in interest and fees from the loan in 2004.

*Sale of HEC.* On December 15, 2004, HEC completed a merger with Chesapeake, under which Chesapeake acquired HEC. The merger agreement provided for a total price of \$292,000,000, which was subject to reduction for certain transaction costs, title discrepancies and other matters, and adjustments for changes in working capital. After these reductions and adjustments, Chesapeake paid a total of \$277,100,000 at the closing, including debt owed by HEC, and management of HEC anticipated that an additional amount would be paid upon final calculation of working capital. The amounts received by HEC stockholders were reduced by additional transaction costs. Accordingly, in exchange for its interest in HEC, the Company received a cash payment of \$53,793,000 in December 2004 and received an additional amount of \$387,000 in April 2005 from the settlement of HEC's working capital. The Company also received its proportionate share of the HE III debt in the amount of \$1,995,000, which it contributed to HE III as an additional capital contribution and its proportionate interest in Hallwood SWD, Inc., the former HEC subsidiary that owned the Worthington saltwater disposal well, with a carrying value of approximately \$1,250,000, which it contributed to HE III as an additional capital contribution. Certain of the Company's officers and directors were investors in HEC. In addition, as members of management of HEC, one director and officer and one officer of the Company held stock options in HEC.

***Hallwood Petroleum, LLC***

*Hallwood Petroleum, LLC.* The Company's former Hallwood Petroleum, LLC subsidiary ( HPL ) commenced operation in October 2004 as an administrative and management company to facilitate record keeping and processing for the energy affiliates and had no financial value. All revenues were credited to, and all costs were borne by, the other energy affiliates with no profit element. All assets nominally in the name of HPL were held solely for the benefit of the other energy affiliates. HPL was formed as a subsidiary of the Company as a convenience and it was not intended that it have any financial impact on the Company. In the 2005 second quarter, the Company determined that its ownership of this pass-through entity created unnecessary complexity, therefore HPL was transferred for nominal consideration to officers of the energy affiliates that are not officers of the Company. The transfer was completed on May 11, 2005. HPL was acquired by Hallwood Energy for nominal consideration in connection with the December 31, 2005 consolidation.

***Other***

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

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 7 Loans Payable**

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

	<b>December 31,</b>	
	<b>2005</b>	<b>2004</b>
<b>Bank Debt</b>		
Revolving credit facility, Libor + 1.75% 3.00% or prime + 0.25% interest, due January 2010	\$ 6,000	\$ 7,977
Equipment term loans, Libor + 3.25% interest, due at various dates from March 2007 through February 2009	812	1,149
	6,812	9,126
<b>Other Debt</b>		
Subordinated secured promissory note, non-interest bearing, repaid February 2005		10
<b>Total</b>	<b>6,812</b>	<b>9,136</b>
Less: Current portion	(352)	(347)
Noncurrent portion	\$ 6,460	\$ 8,789

**Textile Products**

*Revolving Credit Facility.* The Company's Brookwood subsidiary has a revolving credit facility in an amount up to \$22,000,000 with Key Bank National Association (the Key Working Capital Revolving Credit Facility) that was scheduled to mature in January 2007. Borrowings are collateralized by accounts receivable, certain finished goods inventory, machinery and equipment and all of the issued and outstanding capital stock of Brookwood and its subsidiaries. The facility bears interest at Brookwood's option of prime plus 0.25% or Libor + 1.75% 3.00% (variable depending on compliance ratios) and contains two quarterly covenants, including maintenance of a financial ratio, and restrictions on dividends and repayment of debt or cash transfers to the Company. The interest rate was 6.27% and 5.00% at December 31, 2005 and 2004, respectively. The outstanding balance was \$6,000,000 at December 31, 2005 and Brookwood had \$16,000,000 of availability.

*Equipment Term Loans.* Brookwood has a revolving equipment credit facility in an amount up to \$3,000,000 with Key Bank that was scheduled to mature in January 2007. The facility bears interest at Libor plus 3.25%. Monthly principal payments are required for each of the borrowings. The outstanding balance at December 31, 2005 was \$812,000 and Brookwood had \$2,188,000 availability under this equipment credit facility.

*Loan Covenants.* As of the end of all interim periods in 2005 and 2004 and as of December 31, 2005 and 2004, Brookwood was in compliance with its loan covenants. The Key Working Capital Revolving Credit Facility included a total debt to tangible net worth ratio covenant and an EBITDA to fixed charges covenant. Cash dividends and tax sharing payments are contingent upon Brookwood's compliance with the covenants contained in the loan agreement.

On March 25, 2005, Brookwood and Key Bank entered into a loan amendment, which eliminated the borrowing base and certain other loan requirements, including the EBITDA to fixed charges covenant. In addition, the total debt to tangible net worth ratio covenant was reduced to 1.50 from 1.75 and a new covenant was added that Brookwood shall maintain a quarterly minimum net income of not less than one dollar beginning with the quarter ended March 31,

2005.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Renewal of Credit Facilities.* The Key Bank facilities, which had a maturity of January 2007, were renewed in March 2006 for a period of three years with a new maturity of January 30, 2010. The amounts of the respective facilities were unchanged; however, the interest rate on the Key Working Capital Revolving Credit Facility was reduced, at Brookwood's option, to prime or Libor + 1.25% - 1.75% (variable depending on compliance ratios).

*Schedule of Maturities.* Maturities of loans payable for the next five years and thereafter are presented below (in thousands):

Years Ending December 31,	Amount
2006	\$ 352
2007	280
2008	152
2009	28
2010	6,000
Total	\$ 6,812

**Note 8 10% Collateralized Subordinated Debentures**

*Description.* The Company had an issue of 10% Collateralized Subordinated Debentures (the 10% Debentures) outstanding, due July 31, 2005. The 10% Debentures were 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 was amortized over its term. As a result, the effective interest rate was 8.9%. Prior to redemption, the 10% Debentures were secured by a junior lien on the capital stock of Brookwood.

*Redemption.* In August 2004, the Company called the 10% Debentures, with a principal amount of \$6,468,000, for redemption. In September 2004, the Company completed the redemption with debenture holders receiving payments for 100% of the principal amount plus interest through the redemption date.

**Note 9 Deferred Revenue Noncompetition Agreement**

In March 2001, the Company agreed to sell its investment in its former subsidiary, Hallwood Energy Corporation (Former Hallwood Energy), 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 the tender of its 1,440,000 shares of common stock in May 2001 and received an additional amount of \$7,250,000, pursuant to terms of a noncompetition agreement that was paid by Pure upon the completion of the merger in June 2001.

The Company began amortizing the deferred revenue from the noncompetition agreement in the amount of \$7,250,000, over a three-year period commencing June 2001. The amortization was \$1,007,000 and \$2,417,000 in the years ended December 31, 2004 and 2003, respectively. The noncompetition agreement was fully amortized in May 2004.

**Note 10 Redeemable Preferred Stock**

The Company has outstanding 250,000 shares of preferred stock (the Series B Preferred Stock). The holders of Series B Preferred Stock are entitled to cash dividends in an annual amount of \$0.20 per share (total annual amount of \$50,000), which were paid in each of the years beginning in 1996 through and including 2003. No dividend was paid during 2004 and 2005. For the first five years, dividends were cumulative and the payment of cash dividends on any common stock was prohibited before the full payment of

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

any accrued dividends. Beginning in 2001, dividends accrue and are payable only if and when declared by the Board of Directors. The Series B Preferred Stock has dividend and liquidation preferences to the Company's common stock. The shares are subject to mandatory redemption on July 20, 2010, which is fifteen years from the date of issuance, at 100% of the liquidation preference of \$4.00 per share plus all accrued and unpaid dividends, and may be redeemed at any time on the same terms at the option of the Company. The holders of the shares of Series B Preferred Stock are not entitled to vote on matters brought before the Company's stockholders, except as otherwise provided by law.

In connection with the adoption of SFAS No. 150, the Company reclassified its Series B Preferred Stock as a liability at the balance sheet dates. In addition, SFAS No. 150 requires that future payments of preferred dividends shall be classified within continuing operations.

**Note 11 Stockholders' Equity**

*Common Stock.* The Company's Second Restated Certificate of Incorporation contained a provision that restricted transfers of the Company's common stock in order to protect certain federal income tax benefits. The restriction prohibited any transfer of common stock to any person that resulted in ownership in excess of 4.75% of the then outstanding shares. At the May 2004 annual meeting for the Company, the shareholders of the Company voted to amend the Second Restated Certificate of Incorporation by deleting this restriction.

*Preferred Stock.* Under its Second Restated Certificate of Incorporation, the Company is authorized to issue 500,000 shares of preferred stock, par value \$0.10 per share, and did issue 250,000 shares of Redeemable Series B Preferred Stock.

*Treasury Stock.* In August 2003, the Company purchased 35,000 of its common shares in a private transaction for \$604,000. During 2005, 184,875 shares were reissued out of treasury stock in connection with the exercise of stock options by certain directors and officers. The treasury stock account balance was reduced by the average cost per treasury share which aggregated \$2,753,000.

*Stock Options.* All options under the 1995 Stock Option Plan for The Hallwood Group Incorporated were nonqualified stock options. The exercise prices of all options granted were at the fair market value of the Company's common stock on the date of grant, expired ten years from date of grant and were fully vested on the date of grant.

In the 2005 second quarter, the Company's chairman and chief executive officer, and two directors exercised all of their options to purchase a total of 180,000 shares of the Company's common stock, and three officers exercised a portion of their options to purchase an additional 4,875 shares. The Company received proceeds of \$2,207,000 from the exercise of these 184,875 options. The \$546,000 difference between the option proceeds of \$2,207,000 and the average cost of reissued treasury shares of \$2,753,000 was recorded as a reduction in retained earnings.

As of December 31, 2005, the Company had 19,125 fully vested outstanding options, of which 14,625 expire in 2007 and 4,500 in 2010, at an average exercise price of \$15.10 per share. The 1995 Stock Option Plan terminated on June 27, 2005. Options issued prior to the termination are not affected, however no new options can be issued under the 1995 plan.

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A summary of options granted and the changes therein for the 1995 Stock Option Plan during the three years ended December 31, 2005 are presented below:

	Years Ended December 31,					
	2005		2004		2003	
	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
Outstanding, beginning of year	204,000	\$ 12.23	204,000	\$ 12.23	204,000	\$ 12.23
Granted						
Exercised	(184,875)	11.94				
Forfeited						
Reacquired						
Outstanding, end of year	19,125	\$ 15.10	204,000	\$ 12.23	204,000	\$ 12.23
Options exercisable, at end of year	19,125	\$ 15.10	204,000	\$ 12.23	204,000	\$ 12.23

Below is the status of the 1995 Stock Option Plan as of December 31, 2005:

Total authorized	244,800	
Less: Number granted and exercised:		
May 2000	(66,300)	Exercise price of \$10.31, expiring May 2010
September 1997	(56,850)	Exercise price of \$17.37, expiring September 2007
February 1997	(7,500)	Exercise price of \$15.00, expiring February 2007
September 1996	(41,850)	Exercise price of \$7.83, expiring September 2006
June 1995	(12,375)	Exercise price of \$7.67, expiring June 2005
Sub-total	(184,875)	
Less: Number cancelled at expiration of plan in June 2005	(40,800)	
Less: Number granted, not exercised:		
May 2000	(4,500)	Exercise price of \$10.31, expiring May 2010
September 1997	(9,750)	Exercise price of \$17.37, expiring September 2007
February 1997	(4,875)	Exercise price of \$15.00, expiring February 2007
Sub-total	(19,125)	
Total available	-0-	

The Company did not grant any stock options and all options outstanding were fully vested in the three year period ended December 31, 2005; therefore, no pro forma amounts are required to be reported.

**Note 12 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 the former officer and director and related trust exchange their 24% stock ownership in the Company, for certain assets and future cash payments, contingent on the net cash flow from the Company's real estate management activities. The Company had an option to

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extinguish the future cash payments at any time prior to December 21, 2004 upon the payment of \$3,000,000. In June 2004, the Company exercised the option. The Company recognized a gain from extinguishment of the Separation Agreement in the amount of \$375,000, which was the excess of the recorded obligation over the \$3,000,000 exercise price.

**Note 13 Income Taxes**

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

<b>Continuing Operations</b>	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
<b>Federal</b>			
Current	\$ 13,688	\$ 10,390	\$ (5)
Deferred	3,933	(900)	822
Sub-total	17,621	9,490	817
<b>State</b>			
Current	779	1,783	908
Deferred	110	(194)	
Sub-total	889	1,589	908
<b>Total</b>	<b>\$ 18,510</b>	<b>\$ 11,079</b>	<b>\$ 1,725</b>

<b>Discontinued Operations</b>	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
<b>Federal</b>			
Current	\$	\$ 1,207	\$ 73
Deferred		5,143	(5,307)
Sub-total		6,350	(5,234)
<b>State</b>		212	40
<b>Total</b>	<b>\$</b>	<b>\$ 6,562</b>	<b>\$ (5,194)</b>

Reconciliations of the expected tax or (benefit) at the statutory tax rate to the recorded (tax) or benefit are as follows (in thousands):

<b>Years Ended December 31,</b>		
<b>2005</b>	<b>2004</b>	<b>2003</b>



Expected tax at the statutory tax rate	\$ 15,698	\$ 39,244	\$ 1,345
Other	2,236	(3,731)	287
State taxes	578	1,297	625
Foreign loss not taxable	(2)	(2)	(1)
Decrease in deferred tax asset valuation allowance		(19,167)	(5,725)
Recorded tax or (benefit)	\$ 18,510	\$ 17,641	\$ (3,469)

The net deferred tax asset was \$614,000 and \$4,657,000 at December 31, 2005 and 2004, respectively. Prior to 2004, the deferred tax asset was principally attributable to the anticipated utilization of the Company's net operating loss carryforwards ( NOLs ), percentage depletion carryovers, tax credits and timing differences from the implementation of various tax planning strategies, which included anticipated gains from the

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potential sale of investments and projected income from operations. During 2004, the Company utilized its available NOLs, depletion carryovers and tax credits to offset taxable income. Accordingly, at December 31, 2005 and 2004, the deferred tax asset was attributable solely to timing differences, that upon reversal, can be utilized to offset income from operations.

As a result of the appreciation in market value of the HRP limited partner units during 2004 and the establishment of a value for the general partner interest in HRP, principally due to the terms of the Agreement and Plan of Merger with HRPT, and an increase in projected income from operations due to improved results at Brookwood and the Company's energy investments, management determined that its valuation allowance should be eliminated to reflect the anticipated increase in utilization of NOLs and other tax attributes prior to their expiration. Deferred tax expense in 2004 was reduced by the elimination of the valuation allowance, which was \$19,167,000 at December 31, 2003. To the extent that the elimination of the valuation allowance was attributable to the appreciation in market value of the investments in HRP, the deferred tax benefit was allocated to discontinued operations. The deferred tax asset and related tax expense (benefit) in 2003 were impacted by anticipated and realized gains related to the Company's discontinued real estate and hotel operations. Accordingly, the Company recorded a deferred tax expense (benefit) of \$4,043,000, \$4,049,000 and \$(4,485,000) in 2005, 2004 and 2003, respectively.

The Company reported significant taxable income in 2005, principally attributable to the gain from disposition of its investment in HE III and incurred federal current tax expense of \$13,688,000. In 2004, the Company reported taxable income principally as a result of gains from the disposition of its interests in HRP and HEC, net of the utilization of NOLs, depletion carryovers and tax credits and incurred federal current tax expense from continuing and discontinued operations of \$11,597,000. In 2003, the Company reported a small amount of taxable income and incurred federal current tax expense from continuing and discontinued operations of \$68,000, including federal alternative minimum tax of \$20,000. The accrued federal income tax receivable (payable) was \$1,322,000 and \$(1,019,000) and state taxes payable were \$9,000 and \$148,000 at December 31, 2005 and 2004, respectively.

A schedule of the types and amounts of existing temporary differences and NOLs, at the blended statutory tax rate of 35%, as of the balance sheet dates are as follows (in thousands):

	<b>Deferred Tax Asset, Net</b>			
	<b>December 31, 2005</b>		<b>December 31, 2004</b>	
	<b>Assets</b>	<b>Liabilities</b>	<b>Assets</b>	<b>Liabilities</b>
Reserves recorded for financial statement purposes and not for tax purposes	\$ 1,198	\$	\$ 1,054	\$
Basis difference in foreign subsidiary			7,167	
Equity in earnings of unconsolidated affiliates		53		3,667
Depreciation and amortization		531		737
State taxes			194	
Other temporary differences			646	
<b>Deferred tax assets and liabilities</b>	<b>1,198</b>	<b>\$</b>	<b>584</b>	<b>\$</b>
			<b>9,061</b>	<b>\$</b>
				<b>4,404</b>
Less: Deferred tax liabilities	(584)		(4,404)	
<b>Deferred tax asset, net</b>	<b>\$ 614</b>		<b>\$ 4,657</b>	

At December 31, 2003, the Company reported NOLs for tax purposes of \$29,166,000, \$2,249,000 of alternative minimum tax credits and a depletion carryforward of \$6,323,000. All available amounts were utilized in 2004.

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**Note 14 Discontinued Real Estate Operations**

The Company's real estate business segment has been reclassified to discontinued operations as a result of the sale of its investments in HRP and the termination of the associated management contracts (discussed below). A summary of discontinued real estate operations is provided below (in thousands):

	Years Ended December 31,		
	2005	2004	2003
<b>Revenues</b>			
Fees			
Related parties	\$	\$ 2,814	\$ 4,838
Other		247	238
Equity income (loss) from investments in HRP		(2,769)	(436)
		292	4,640
<b>Expenses</b>			
Administrative expenses		877	1,564
Litigation costs		50	3,371
Amortization			560
		927	5,495
Income (loss) from operations		(635)	(855)
Gain from sale			
Gain from sale of investments in HRP		52,703	
Incentive compensation and transaction costs		(6,629)	
		46,074	
Income (loss) before income taxes		45,439	(855)
<b>Income taxes</b>			
Current federal and state income tax expense		1,294	113
Deferred federal income tax expense (benefit)		5,143	(5,307)
		6,437	(5,194)
Income from discontinued real estate operations	\$	\$ 39,002	\$ 4,339

Prior to its sale in July 2004, the Hallwood Realty and HWG, LLC, wholly owned subsidiaries of the Company, owned a 1% general partner interest and a 21% limited partner interest, respectively, in its HRP affiliate. The Company accounted 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 recorded 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).

*Management of HRP.* Prior to the HRP's sale to HRPT, the Company's real estate subsidiaries earned asset management, property management, leasing and construction supervision fees for their management of HRP's real estate properties. The management contracts with HRP, which were scheduled to expire on

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June 30, 2004, were amended in April 2004 to expire on the closing date of the merger with HRPT, which was completed July 16, 2004. A summary of the fees earned from HRP is detailed below (in thousands):

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
Property management fees	\$	\$ 1,127	\$ 1,979
Leasing fees		866	1,556
Construction supervision fees		486	698
Asset management fees		335	605
<b>Total</b>	<b>\$</b>	<b>\$ 2,814</b>	<b>\$ 4,838</b>

The management contracts with HRP were terminated on July 16, 2004 in connection with HRP's sale to HRPT. Hallwood Realty was 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 did not employ any individuals, the compensation and other costs related to approximately 90 employees rendering services on behalf of HRP and its properties were reimbursed to Hallwood Realty and HCRE by HRP.

*Disposition.* In July 2004, a merger with a subsidiary of HRPT was approved by the HRP unitholders at the special meeting of unitholders with holders of 53.74% of the outstanding units voting to approve the merger, and on July 16, 2004, HRP announced the completion of the merger. The total cash price HRPT paid under the merger agreement and the purchase agreement was approximately \$247,000,000. In addition, HRPT assumed or prepaid all of HRP's outstanding debt. In July 2004, the Company received proceeds of approximately \$66,060,000 from the sale of its interests, of which \$18,500,000 was placed into an escrow account pending the resolution of certain claims. In December 2004, the pending claims were resolved, and the Company received the full amount of the \$18,500,000 escrow deposit plus accrued interest. The Company used approximately \$14,400,000 of the proceeds to repay principal, accrued interest and fees associated with the Amended and Restated Credit Agreement. See Note 7.

In its announcement, HRP indicated that unitholders received an amount in cash equal to \$136.70 per unit of limited partnership. Of this amount \$0.31 per unit was withheld subject to the award of attorney's fees to the class counsel in the *I.G. Holdings Inc. et al v. Hallwood Realty, LLC et al.* litigation. Proceeds were also reduced by approximately \$102,000 for the Company's share of the award of attorneys' fees to the class counsel in the *I.G. Holdings* litigation. In February 2005, the Company received approximately \$59,000, which was its allocable share of the remaining escrow account balance from the *I.G. Holdings* litigation.

*Gain from Sale.* The gain from sale of investments in HRP of \$52,703,000 resulted from the receipt of \$66,119,000 in the merger less the carrying value of the investments in the general partnership and limited partnership interests of approximately \$13,416,000. In connection with the sale of HRP and the substantial benefits the Company received from the operations of HRP over a number of years, a special committee, consisting of independent members of the board of directors of the Company, authorized an additional incentive compensation payment of \$1,622,000 to Mr. Guzzetti, the Company's executive vice president and payments of \$1,908,000 to Mr. Gumbiner and \$3,000,000 to Hallwood Investments Limited, a corporation associated with Mr. Gumbiner. Transaction costs were \$99,000.

*Dissolution.* Following the board of directors' determination to discontinue the Company's real estate activities effective January 1, 2005, the Company completed a dissolution of all of its real estate subsidiaries during 2005.

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**Note 15 Discontinued Hotel Operations**

In December 2000, the Company decided to discontinue its hotel operations and to dispose of its hotel segment, principally 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 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. In December 2004, the Company's Brock Suites Huntsville, Inc. subsidiary entered into a Lease Termination and Mutual Release Agreement with the landlord of the GuestHouse Suites Plus hotel in Huntsville, Alabama. In connection with the lease termination, the remaining assets of the subsidiary were transferred to the landlord, and the Company obtained a release from any further obligations. The Company recognized a gain from extinguishment of debt of \$1,598,000. Operating results for the Huntsville hotel were reclassified as discontinued operations. A summary of discontinued hotel operations for the three years ended December 31, 2005 is provided below (in thousands):

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
<b>Revenues</b>			
Gain from extinguishment of debt	\$	\$ 1,598	\$
Sales		1,499	1,414
		3,097	1,414
<b>Expenses</b>			
Operating expenses		1,987	1,799
Depreciation and amortization		188	115
Interest expense		10	37
Litigation and other disposition costs		5	31
		2,190	1,982
Income (loss) before income taxes		907	(568)
Income tax expense		124	
Income (loss) from discontinued hotel operations	\$	\$ 783	\$ (568)

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**Note 16 Supplemental Disclosures to the Consolidated Statements of Cash Flows**

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

*Supplemental schedule of non-cash investing and financing activities.*

	Years Ended December 31,		
	2005	2004	2003
<b>Transfer of HPL net assets to officers of the energy affiliates:</b>			
Restricted cash	\$ 218	\$	\$
Prepays, deposits and other assets	85		
Property, plant and equipment, net	588		
Other noncurrent assets	138		
Accounts payable	(584)		
Accrued expenses and other current liabilities	(445)		
	\$	\$	\$
<b>Income tax effect from exercise of stock options:</b>			
Income taxes payable	\$ (1,466)	\$	\$
Additional paid-in capital	1,466		
	\$	\$	\$
<b>Issuance of promissory note in litigation settlement</b>			
			\$ 250
<b>Proportionate share of partners' capital transactions of equity investments</b>			
Sale of real estate investments	\$	\$ 257	\$
Exercise of stock options			(23)
Amortization of interest rate swap		(30)	(56)
	\$	\$ 227	\$ (79)
<b>Hotel assets and liabilities relinquished in connection with debt extinguishment:</b>			
Other liabilities, net	\$	\$ 1,598	\$
<i>Supplemental disclosures of cash payments.</i>			
Interest paid	\$ 455	\$ 1,299	\$ 1,680
Income taxes paid	15,158	12,903	967



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**Note 17 Computation of Income Per Common Share**

The following table reconciles weighted average shares outstanding from basic to assuming dilution and reconciles income from continuing operations after preferred dividend and net income available to common stockholders used in the computation of income per share for the basic and assuming dilution methods (in thousands):

	Years Ended December 31,		
	2005	2004	2003
<b>Weighted Average Shares Outstanding</b>			
Basic	1,446	1,326	1,347
Potential shares from assumed exercise of stock options	88	204	125
Potential repurchase of shares from stock options proceeds	(26)	(43)	(82)
Assuming dilution	1,508	1,487	1,390
<b>Net Income Available to Common Stockholders</b>			
Basic and assuming dilution	\$ 26,342	\$ 94,485	\$ 7,375

**Note 18 Fair Value of Financial Instruments**

Estimated fair value amounts have been determined using available market information or other appropriate valuation methodologies that require considerable judgment in interpreting market data and developing estimates. Accordingly, the estimates presented herein are not necessarily indicative of the amounts that the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

The fair value of financial instruments that are short-term or reprice frequently and have a history of negligible credit losses are considered to approximate their carrying value. These include cash and cash equivalents, short term receivables, accounts payable and other liabilities.

Management has reviewed the carrying value of its loans payable in connection with interest rates currently available to the Company for borrowings with similar characteristics and maturities. Management has determined that the estimated fair value of the loans payable would be approximately \$6,837,000 and \$9,095,000 at December 31, 2005 and 2004, compared to the carrying value of \$6,812,000 and \$9,136,000, respectively.

The fair value information presented as of December 31, 2005 and 2004 is based on pertinent information available to management. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since that date and, therefore current estimates of fair value may differ significantly from the amounts presented herein.

**Note 19 Related Party Transactions**

*Hallwood Investments Limited.* The Company has entered into a financial consulting contract with Hallwood Investments Limited ( HIL ), a corporation associated with Mr. Anthony J. Gumbiner, the Company's chairman and principal stockholder. The contract provides for HIL to furnish and perform international consulting and advisory services to the Company and its subsidiaries, including strategic planning and merger activities, for annual compensation of \$996,000 (\$954,000 prior to March 2005 and \$795,000 prior to March 2004). The annual amount is payable in monthly installments. This contract automatically renews for one-year periods if not terminated by the parties beforehand. Additionally, HIL and Mr. Gumbiner are



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also eligible for bonuses from the Company or its subsidiaries, subject to approval by the Company or its subsidiaries board of directors. The Company also reimburses HIL for reasonable expenses in providing office space and administrative services. Of the amounts paid, the Company's share of such expenses was \$557,000, \$324,000 and \$104,000 of expense for the years ended December 31, 2005, 2004 and 2003, respectively. The remainder was reimbursed by HRP prior to its disposition in July 2004.

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

	Years Ended December 31,		
	2005	2004	2003
Bonus	\$ 5,000	\$ 4,908	\$ 33
Consulting fees	989	928	795
Office space and administrative services	557	324	104
<b>Total</b>	<b>\$ 6,546</b>	<b>\$ 6,160</b>	<b>\$ 932</b>

A special committee, consisting of independent members of the board of directors, awarded a \$5,000,000 bonus to Mr. Gumbiner, in consideration of the significant profits and long-term gains realized by the Company as a result of Mr. Gumbiner's performance over an extended period. The bonus was paid in July 2005.

In connection with the sale of HRP in July 2004 and the substantial benefits the Company received from the operations of HRP over a number of years, a special committee authorized additional incentive compensation payments of \$1,908,000 to Mr. Gumbiner and \$3,000,000 to HIL. The bonuses were paid in September and October 2004, respectively. As these incentive compensation costs related to HRP, the costs were reported within the discontinued real estate operations.

In March 2004 the board of directors awarded HIL a bonus of \$33,000 from its HCRE subsidiary which was accrued in 2003.

In addition, HIL and Mr. Gumbiner perform services for certain affiliated entities that are not subsidiaries of the Company, for which they receive consulting fees, bonuses, stock options, net profit interests or other forms of compensation and expenses. The Company recognizes a proportionate share of such compensation and expenses, based upon its ownership percentage in the affiliated entities, through the utilization of the equity method of accounting.

Beginning January 1, 2005, HIL shares common offices, facilities and certain staff in its Dallas office with the Company. The Company pays certain common general and administrative expenses and charges HIL an overhead reimbursement fee for its allocable share of the expenses. For the year ended December 31, 2005, HIL reimbursed the Company \$113,000 for such expenses.

*Hallwood Energy, L.P.* Beginning August 1, 2005, Hallwood Energy and its predecessor entities shares common offices, facilities and certain staff with the Company. Hallwood Energy reimburses the Company for its allocable share of the expenses. For the five month period ended December 31, 2005, Hallwood Energy reimbursed the Company \$59,000 for such expenses.

*Hallwood Realty Partners, L.P.* The Company earned management fees, leasing commissions and other fees from HRP prior to the sale of its investments in July 2004. See Note 14.

**Note 20 Litigation, Contingencies and Commitments**

*Litigation.* From time to time, the Company, certain of its affiliates and others have been named as defendants in lawsuits relating to various transactions in which it or its affiliated entities participated. In the



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Company's opinion, no litigation in which the Company, subsidiaries or affiliates is a party is likely to have a material adverse effect on its financial condition, results of operations or cash flows.

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

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

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

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

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

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

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

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

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

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

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

*Commitments.* Total lease expense for noncancelable operating leases was \$812,000, \$1,515,000 and \$1,431,000 for the years ended December 31, 2005, 2004 and 2003, respectively. The Company leases certain textile manufacturing equipment and one hotel property (prior to its disposition in December 2004), including land, buildings and equipment. The leases generally require the Company to pay property taxes, insurance and maintenance of the leased assets. The Company shares certain executive office facilities with Hallwood Energy, HIL and HRP (prior to its disposition in July 2004) and pays a proportionate share of the lease expense.

At December 31, 2005 aggregate minimum annual rental commitments under noncancelable operating leases having an initial or remaining term of more than one year, were as follows (in thousands):

<b>Years Ending December 31,</b>	<b>Amount</b>
2006	\$ 942
2007	510
2008	483
2009	195
2010	195
Thereafter	
<b>Total</b>	<b>\$ 2,325</b>

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Employment Contracts.* The Company's Brookwood subsidiary has an employment agreement with one key employee that expires in 2006. The approximate compensation commitment due under this agreement at December 31, 2005 was \$50,000.

**Note 21 Segment and Related Information**

The Company is a holding company and classifies its continuing business operations into two reportable segments; textile products and energy. Both segments have different management teams and infrastructures that engage in different businesses and offer different services. See Notes 5 and 6.

The Company's discontinued operations are comprised of its former real estate and hotel segments. See Notes 14 and 15.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following represents the Company's reportable amounts by business segment and discontinued operations, as of and for the three years ended December 31, 2005 (in thousands):

	Textile Products	Energy	Other	Discontinued Operations	Consolidated
<b>Year Ended December 31, 2005</b>					
Total revenue from external sources	\$ 133,108	\$ 1,499			\$ 134,607
Operating income (loss)	\$ 11,677		\$ (11,624)		\$ 53
Other income (loss), net	\$ (545)	\$ 43,812	\$ 1,532		44,799
Income from continuing operations before income taxes					\$ 44,852
Income from discontinued operations					
Identifiable assets, December 31, 2005	\$ 48,132	\$ 40,854			\$ 88,986
Cash allocable to segment	281		\$ 16,367		16,648
	\$ 48,413	\$ 40,854	\$ 16,367		105,634
Corporate assets			\$ 3,167		3,167
Total assets, December 31, 2005					\$ 108,801
Depreciation and amortization	\$ 1,738	\$ 97	\$ 15		\$ 1,850
Capital expenditures/acquisitions	\$ 2,654	\$ 69	\$ 3		\$ 2,726
<b>Year Ended December 31, 2004</b>					
Total revenue from external sources	\$ 136,276	\$ 1,004			\$ 137,280
Operating income (loss)	\$ 18,460		\$ (6,789)		\$ 11,671
Other income (loss), net	\$ (398)	\$ 52,387	\$ 2,119		54,108
Income from continuing operations before income tax					\$ 65,779
Income from discontinued operations				\$ 39,785	\$ 39,785
Identifiable assets, December 31, 2004	\$ 60,238	\$ 13,347		\$ 329	\$ 73,914
Cash allocable to segment	228	218	\$ 71,321		71,767
	\$ 60,466	\$ 13,565	\$ 71,321	\$ 329	145,681



Corporate assets					\$ 11,636	11,636
Total assets, December 31, 2004						\$ 157,317
Depreciation and amortization	\$ 1,618	\$ 57	\$ 7	\$ 188		\$ 1,870
Capital expenditures/acquisitions	\$ 2,651	\$ 689	\$ 21			\$ 3,361

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	Textile Products	Energy	Other	Discontinued Operations	Consolidated
<b>Year Ended December 31, 2003</b>					
Total revenue from external sources	\$ 104,720				\$ 104,720
Operating income (loss)	\$ 6,672		\$ (2,097)		\$ 4,575
Other income (loss), net	\$ (641)	\$ 50	\$ 1,395		804
Income from continuing operations before income tax					\$ 5,379
Income from discontinued operations				\$ 3,771	\$ 3,771
Identifiable assets, December 31, 2003	\$ 49,603	\$ 5,360		\$ 23,938	\$ 78,901
Cash allocable to segment	916		\$ 1,884	85	2,885
	\$ 50,519	\$ 5,360	\$ 1,884	\$ 24,023	81,786
Corporate assets			\$ 1,768		1,768
Total assets, December 31, 2003					\$ 83,554
Depreciation and amortization	\$ 1,504			\$ 671	\$ 2,175
Capital expenditures/acquisitions	\$ 1,561				\$ 1,561

**Note 22 Employee Benefit Retirement Plans**

In August 1989, the Company established a contributory, tax-deferred 401(k) tax favored savings plan covering substantially all of its non-union employees. The plan provides that (i) eligible employees may contribute up to 15% of their compensation to the plan; (ii) the Company's matching contribution is discretionary, to be determined annually by the Company's Board of Directors; (iii) excludes the Company's hotel hourly employees from a matching contribution; and (iv) excludes highly compensated employees from a matching contribution, although this group receives a compensatory bonus in lieu of such contribution and diminution of related benefits. Amounts contributed by employees are 100% vested and non-forfeitable. The Company's matching contributions, which were 50% of its employees' contributions up to the first 6% contributed, for each of the years ended December 31, 2005 and 2003, vest at a rate of 20% per year of service and become fully vested after five years. The Company did not provide a matching contribution in 2004. Employees of Hallwood Realty, HCRE and salaried hotel employees also participated in the Company's 401(k) plan. Employer contributions paid on behalf of Hallwood Realty employees were substantially paid by HRP. Brookwood has a separate 401(k) plan which is similar to the Company's plan. Aggregate contributions to the plans for the years ended December 31, 2005, 2004 and 2003, respectively, excluding contributions from HRP, were \$283,000, \$205,000 and \$291,000, respectively.

Brookwood's union employees belong to a pension fund maintained by their union. The Company contributes \$90 per month per employee to the fund. Total contributions for the three years ended December 31, 2005 were

\$306,000, \$302,000 and \$281,000, respectively.

**Note 23 Cash Dividends**

*May 2005.* On April 22, 2005, the Company announced a cash distribution in partial liquidation to stockholders and an equivalent bonus to option holders. The cash distribution in the amount of \$37.70 per share, totaling approximately \$56,789,000, was paid on May 27, 2005 to stockholders of record as of May 20,

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

2005. The distribution was in partial liquidation of the Company, as a result of the Company's disposition of its real estate interests and partnership units relating to HRP in July 2004, and the board of directors' determination to discontinue the Company's real estate activities effective January 1, 2005. In connection with the plan of partial liquidation, the board of directors determined to review the cash position of the Company at any time through December 31, 2005, and consider declaring additional liquidating distributions not to exceed (together with the May distribution) the approximately \$66,119,000 received in the disposition of the HRP interests.

In connection with the cash distribution, a special committee of the board of directors of the Company declared a special bonus to those officers of the Company, other than Mr. Gumbiner, who held outstanding options to purchase common stock of the Company, in lieu of amounts such holders would have received if they had exercised their options prior to the record date. The special bonus was equal to the amount of the cash distribution per share on the number of shares subject to options that each individual held as of the record date, and totaled approximately \$905,000.

*August 2005.* On July 27, 2005 the Company announced an additional cash distribution in partial liquidation to stockholders and an equivalent bonus to option holders. This cash distribution in the amount of \$6.17 per share, totaling approximately \$9,324,000, was paid on August 18, 2005 to stockholders of record as of August 12, 2005. The two distributions approximate the total amount received from the disposition of its real estate interests and partnership units.

In connection with the additional cash distribution, the board of directors declared a special bonus to those officers of the Company who held outstanding options to purchase common stock of the Company, in lieu of amounts such holders would have received if they exercised their options prior to the record date. The special bonus was equal to the amount of the cash distribution per share on the number of shares subject to options that each individual held on the record date, and totaled approximately \$118,000.

**Note 24 Summary of Quarterly Financial Information (Unaudited)**

Results of operations by quarter for the years ended December 31, 2005 and 2004, are summarized below (in thousands, except per share amounts):

	<b>Year Ended December 31, 2005</b>			
	<b>March 31</b>	<b>June 30</b>	<b>September 30</b>	<b>December 31</b>
Operating revenues	\$ 37,326	\$ 35,857	\$ 30,239	\$ 31,185
Other income	97	532	43,716	454
Gross profit	8,646	8,035	6,479	6,148
Income (loss) from continuing operations	906	(4,317)	28,935	818
Income from discontinued operations				
Net income (loss)	906	(4,317)	28,935	818
Comprehensive income				
Per share data:				
Income (loss) from continuing operations				
Basic	0.68	(3.02)	19.15	0.54
Assuming dilution	0.60	(3.02)	18.95	0.54
Net income (loss)				
Basic	0.68	(3.02)	19.15	0.54
Assuming dilution	0.60	(3.02)	18.95	0.54



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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Year Ended December 31, 2004**

	<b>March 31</b>	<b>June 30</b>	<b>September 30</b>	<b>December 31</b>
Operating revenues	\$ 31,240	\$ 35,554	\$ 31,277	\$ 39,209
Other income	298	827	528	52,455
Gross profit	7,017	9,713	8,539	9,239
Income from continuing operations	5,318	10,660	803	37,919
Income from discontinued operations	8,401	2,967	27,813	604
Net income	13,719	13,627	28,616	38,523
Comprehensive income	13,704	13,612	28,616	38,523
Per share data:				
Income from continuing operations				
Basic	4.01	8.04	0.61	28.60
Assuming dilution	3.68	7.27	0.54	25.18
Net income				
Basic	10.35	10.28	21.58	29.05
Assuming dilution	9.50	9.30	19.24	25.58

*Year ended December 31, 2005.* In July 2005, the Company completed a sale of its investment in HE III and reported a gain from the sale of \$51,956,000. The gain was reported in continuing operations.

*Year ended December 31, 2004.* In July 2004, the Company completed a sale of its former investments in HRP and reported a gain from the sale in the amount of \$46,074,000. The gain is reported in discontinued operations. In December 2004, the Company completed a sale of its investment in HEC and reported a gain from the sale in the amount of \$62,288,000. The gain was reported in continuing operations. In December 2004, the Company entered into a lease termination agreement for its one remaining hotel and reported a gain in the amount of \$1,598,000. This gain was reported in discontinued operations.

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**INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM'S REPORT ON SCHEDULES**

To the Stockholders and Directors of  
The Hallwood Group Incorporated

We have audited the consolidated balance sheets of The Hallwood Group Incorporated and subsidiaries as of December 31, 2005 and 2004 and the related consolidated statements of operations, comprehensive income, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2005 and have issued our report thereon dated April 11, 2006, and which report is included elsewhere in this Form 10-K. Our audits also included the financial statement schedules of The Hallwood Group Incorporated and subsidiaries, listed in the accompanying index at Item 15. These financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion based on our audits. In our opinion, such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly in all material respects the information set forth therein.

DELOITTE & TOUCHE LLP

Dallas, Texas

April 11, 2006

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**SCHEDULE I**  
**CONDENSED FINANCIAL INFORMATION OF REGISTRANT (PARENT COMPANY)**  
**BALANCE SHEETS**  
(In thousands)

	<b>December 31,</b>	
	<b>2005</b>	<b>2004</b>
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 16,310	\$ 71,196
Prepaid income taxes	1,322	
Deferred income tax	945	2,213
Receivables and other current assets	728	732
Marketable securities		6,100
	19,305	80,241
<b>Noncurrent Assets</b>		
Investments in energy affiliates	40,854	12,491
Investments in subsidiaries	31,056	33,006
Other noncurrent assets	113	124
Deferred tax asset		2,250
	72,023	47,871
<b>Total Assets</b>	<b>\$ 91,328</b>	<b>\$ 128,112</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable and accrued expenses	\$ 1,375	\$ 1,394
Income taxes payable	94	1,177
	1,469	2,571
<b>Noncurrent Liabilities</b>		
Redeemable preferred stock	1,000	1,000
Deferred tax liability	416	
	1,416	1,000
<b>Total Liabilities</b>	<b>2,885</b>	<b>3,571</b>
<b>Stockholders Equity</b>		
Common stock	240	240
Additional paid-in capital	56,258	54,792
Retained earnings	45,126	85,443
Treasury stock, at cost	(13,181)	(15,934)



<b>Total Stockholders Equity</b>	88,443	124,541
<b>Total Liabilities and Stockholders Equity</b>	<b>\$ 91,328</b>	<b>\$ 128,112</b>

The Notes to Consolidated Financial Statements of The Hallwood Group Incorporated and Subsidiaries are an integral part of these statements.

See accompanying Notes to Condensed Financial Information of Registrant .

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**SCHEDULE I (Continued)**  
**CONDENSED FINANCIAL INFORMATION OF REGISTRANT (PARENT COMPANY)**  
**STATEMENTS OF OPERATIONS**  
(In thousands)

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
<b>Revenues</b>	\$	\$	\$
<b>Expenses</b>	11,019	4,305	2,086
Operating Loss	(11,019)	(4,305)	(2,086)
<b>Other Income (Loss)</b>			
Gain from disposition of investments in energy affiliates:			
HE III	52,425		
HEC	(113)	62,288	
Equity income (loss) from investments in energy affiliates	(8,500)	(9,901)	50
Equity in net income of subsidiaries continuing operations	5,764	8,511	2,987
Interest and other income (expense)	1,539	1,434	(27)
Amortization of deferred revenue noncompetition agreement		1,007	2,417
Interest expense		(504)	(672)
Separation Agreement income		375	
	51,115	63,210	4,755
Income from continuing operations before income tax	40,096	58,905	2,669
Income tax expense (benefit)	13,754	4,205	(985)
Income from continuing operations	26,342	54,700	3,654
Income from discontinued operations, net of tax			
Real estate		39,002	4,339
Hotels		783	(568)
		39,785	3,771
<b>Net Income</b>	26,342	94,485	7,425
Cash dividend on redeemable preferred stock			(50)
<b>Net Income Available to Common Stockholders</b>	\$ 26,342	\$ 94,485	\$ 7,375

The Notes to Consolidated Financial Statements of The Hallwood Group Incorporated and Subsidiaries are an integral part of these statements.

See accompanying Notes to Condensed Financial Information of Registrant .



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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**SCHEDULE I (Continued)**  
**CONDENSED FINANCIAL INFORMATION OF REGISTRANT (PARENT COMPANY)**  
**STATEMENTS OF COMPREHENSIVE INCOME**  
(In thousands)

	Years Ended December 31,		
	2005	2004	2003
<b>Net Income</b>	\$ 26,342	\$ 94,485	\$ 7,425
Other Comprehensive Income (Loss)			
Pro rata share of other comprehensive income from equity investments:			
Sale of real estate investments		(105)	
Amortization of interest rate swap		(30)	(56)
		(135)	(56)
<b>Comprehensive Income</b>	\$ 26,342	\$ 94,350	\$ 7,369

The Notes to Consolidated Financial Statements of The Hallwood Group Incorporated and Subsidiaries are an integral part of these statements.

See accompanying Notes to Condensed Financial Information of Registrant .

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**SCHEDULE I (Continued)**  
**CONDENSED FINANCIAL INFORMATION OF REGISTRANT (PARENT COMPANY)**  
**STATEMENTS OF CASH FLOWS**  
(In thousands)

	Years Ended December 31,		
	2005	2004	2003
<b>NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES</b>	\$ (6,174)	\$ (17,020)	\$ 2,673
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Proceeds from sale of investment in HE III	55,648		
Investments in energy affiliates	(40,556)	(11,032)	(1,997)
Return of (additional) investment in subsidiaries	(285)	48,897	2,029
Proceeds from sale of investment in HEC	387	55,788	
Net cash provided by investing activities	15,194	93,653	32
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Cash dividends on common stock	(66,113)		
Proceeds from exercise of stock options	2,207		
Redemption of 10% Debentures		(6,468)	
Repayment of bank borrowings and loans payable		(730)	(586)
Purchase of common stock for treasury			(604)
Cash dividend on preferred stock			(50)
Net cash (used in) financing activities	(63,906)	(7,198)	(1,240)
<b>INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	(54,886)	69,435	1,465
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR</b>	71,196	1,761	296
<b>CASH AND CASH EQUIVALENTS, END OF YEAR</b>	\$ 16,310	\$ 71,196	\$ 1,761

The Notes to Consolidated Financial Statements of The Hallwood Group Incorporated and Subsidiaries are an integral part of these statements.

See accompanying Notes to Condensed Financial Information of Registrant .

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**SCHEDULE I (Continued)**  
**CONDENSED FINANCIAL INFORMATION OF REGISTRANT (PARENT COMPANY)**  
**STATEMENTS OF CASH FLOWS**  
**(In thousands)**

*Supplemental schedule of non-cash investing and financing activities.* The following transactions affected recognized assets or liabilities but did not result in cash receipts or cash payments (in thousands):

Description	Years Ended December 31,		
	2005	2004	2003
<i>Income tax effect from exercise of stock options:</i>			
Income taxes payable	\$ (1,466)	\$	\$
Additional paid-in capital	1,466		
	\$	\$	\$
Issuance of promissory note in litigation settlement	\$	\$	\$ 250
<i>Proportionate share of partners' capital transactions of equity investments</i>			
Sale of real estate investments	\$	\$ 257	\$
Amortization of interest rate swap		(30)	(56)
	\$	\$ 227	\$ (56)
<i>Supplemental disclosures of cash payments</i>			
Interest paid	\$	\$ 594	\$ 675
Income taxes paid	14,620	10,483	223

The Notes to Consolidated Financial Statements of The Hallwood Group Incorporated and Subsidiaries are an integral part of these statements.

See accompanying Notes to Condensed Financial Information of Registrant .

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**SCHEDULE I (Continued)**  
**CONDENSED FINANCIAL INFORMATION OF REGISTRANT (PARENT COMPANY)**  
**NOTES TO CONDENSED FINANCIAL STATEMENTS**

**Note 1 Basis of Presentation**

Pursuant to the rules and regulations of the Securities and Exchange Commission, the condensed financial statements of the Registrant do not include all of the information and notes normally included with financial statements prepared in accordance with accounting principles generally accepted in the United States of America. In addition, for purposes of this schedule, the investments in majority owned subsidiaries are accounted for using the equity method of accounting which is not in accordance with accounting principles generally accepted in the United States of America. It is, therefore suggested that these condensed financial statements be read in conjunction with the consolidated financial statements and notes thereto included in the Registrant's annual report as referenced in Form 10-K, Part II, Item 8.

**Note 2 Dividends From Subsidiaries**

The Company received dividends from its Brookwood subsidiary of \$8,000,000, \$3,000,000 and \$600,000 in 2005, 2004 and 2003, respectively. The Company also received a \$2,000,000 dividend payment in March 2006.

**Note 3 Income From Discontinued Operations**

In July 2004, the Company sold its real estate business segment. Accordingly, results for the real estate operations have been reclassified to discontinued operations. Discontinued real estate operations for the three years ended December 31, 2005 consist of the following (in thousands):

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
Equity in net income of real estate subsidiaries	\$	\$ 51,908	\$ 2,403
Income tax (expense) benefit		(6,226)	5,307
Incentive compensation and transaction costs		(6,629)	
Provision for loss		(51)	(3,371)
<b>Income from discontinued real estate operations</b>	<b>\$</b>	<b>\$ 39,002</b>	<b>\$ 4,339</b>

In December 2000, the Company decided to discontinue its hotel operations and to dispose of its hotel segment, principally by allowing its non-recourse debt holders 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. The Company determined that it would retain its leasehold interest in the GuestHouse Suites Plus hotel in Huntsville, Alabama. The Company continued to operate the hotel, subject to a lease concession, from the owner, until it entered into a lease termination

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**SCHEDULE I (Continued)**

**CONDENSED FINANCIAL INFORMATION OF REGISTRANT (PARENT COMPANY)**

agreement in December 2004. Discontinued hotel operations for the three years ended December 31, 2005 consists of the following (in thousands):

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
Gain from lease termination	\$	\$ 1,598	\$
Equity in net loss of hotel subsidiaries		(686)	(537)
Income tax expense		(124)	
Litigation and other disposition costs		(5)	(31)
<b>Income (loss) from discontinued hotel operations</b>	<b>\$</b>	<b>\$ 783</b>	<b>\$ (568)</b>

**Note 4 Litigation, Contingencies and Commitments**

See Note 20 to the consolidated financial statements.



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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**SCHEDULE II**  
**VALUATION AND QUALIFYING ACCOUNTS AND RESERVES**  
(In thousands)

	Balance, Beginning of Year	Charged to (Recovery of) Costs and Expenses	Charged to Other Accounts	Deductions	Balance, End of Year
<b>Textile Products</b>					
Allowance for losses accounts receivable:					
Year ended December 31, 2005	\$ 253	\$ (189)		\$	\$ 64
Year ended December 31, 2004	509	29		(285)(a)	253
Year ended December 31, 2003	310	252		(53)(a)	509
<b>Deferred Tax Asset</b>					
Valuation allowance					
Year ended December 31, 2005	\$	\$		\$	\$
Year ended December 31, 2004	19,167	(19,167)			
Year ended December 31, 2003	24,892	(5,725)			19,167

Notes:

(a) Write-offs, net of recoveries

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***Hallwood Energy, L.P. and Subsidiaries***  
*Consolidated Financial Statements*  
*Years Ended December 31, 2005 and 2004 (unaudited)*  
*And Report of Independent Registered*  
*Public Accounting Firm*

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the Partners of Hallwood Energy, L.P.**

**Dallas, Texas**

We have audited the accompanying consolidated balance sheet of Hallwood Energy, L.P. and subsidiaries (the Partnership ) as of December 31, 2005, and the related consolidated statements of operations, partners' capital, and cash flows for the year then ended. These financial statements are the responsibility of the Partnership's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Partnership is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Partnership's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Hallwood Energy, L.P. and subsidiaries as of December 31, 2005, and the consolidated results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

DELOITTE & TOUCHE LLP

Dallas, Texas

April 11, 2006

**Table of Contents****HALLWOOD ENERGY, L.P. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS**

	December 31,	
	2005	2004
		(Unaudited)
<b>ASSETS</b>		
<b>Current Assets:</b>		
Cash and cash equivalents	\$ 91,235,979	\$ 13,593,767
Accounts receivable	168,571	234,713
Prepaid expenses	101,066	3,842
Restricted cash	76,884	50,000
	91,582,500	13,882,322
<b>Property and Equipment:</b>		
Using the full cost method of accounting		
Unproved, unevaluated leasehold costs	57,300,562	3,977,695
Work in progress	4,086,425	
Office equipment	505,694	790,422
Gathering facilities	8,009	
	61,900,690	4,768,117
Accumulated depreciation and amortization	(243,880)	(157,679)
	61,656,810	4,610,438
<b>Other Assets:</b>		
Tubular inventory	11,002,225	
Deposits	98,110	87,610
	11,100,335	87,610
<b>Total Assets</b>	<b>\$ 164,339,645</b>	<b>\$ 18,580,370</b>
<b>LIABILITIES AND PARTNERS CAPITAL</b>		
<b>Current Liabilities:</b>		
Accounts payable and accrued expenses	\$ 5,581,484	\$ 1,642,536
Advances from limited partners	1,966,164	
Accounts payable to affiliate		637,008
Advances from third parties	310,177	
	7,857,825	2,279,544
<b>Partners Capital:</b>		
Limited partners	156,466,172	16,236,659

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General partner	15,648	64,167
	156,481,820	16,300,826
<b>Total Liabilities and Partners Capital</b>	<b>\$ 164,339,645</b>	<b>\$ 18,580,370</b>

See accompanying notes to consolidated financial statements.

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**HALLWOOD ENERGY, L.P. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS**

	<b>For the Years Ended December 31,</b>	
	<b>2005</b>	<b>2004</b>
		<b>(Unaudited)</b>
<b>Income:</b>		
Interest and other	\$ 357,228	\$ 105,752
	357,228	105,752
<b>Expenses:</b>		
General and administrative	2,062,056	47,312
Depreciation and amortization	211,199	157,679
Loss on disposition of office equipment	208,801	
	2,482,056	204,991
<b>Loss before gain from sale of undeveloped leaseholds</b>	<b>(2,124,828)</b>	<b>(99,239)</b>
Gain from sale of undeveloped leaseholds	2,751,090	
<b>Net income (loss)</b>	<b>\$ 626,262</b>	<b>\$ (99,239)</b>

See accompanying notes to consolidated financial statements.

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**HALLWOOD ENERGY, L.P. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF PARTNERS' CAPITAL**  
**For the Years Ended December 31, 2005 and 2004 (unaudited)**

	<b>Limited Partners</b>	<b>General Partner</b>	<b>Total</b>
<b>Balance, January 1, 2004 (unaudited)</b>	\$	\$	\$
Net loss (unaudited)	(98,823)	(416)	(99,239)
Partners' capital contributions (unaudited)	16,335,482	64,583	16,400,065
<b>Balance, December 31, 2004 (unaudited)</b>	16,236,659	64,167	16,300,826
Net income	626,199	63	626,262
Partners' capital contributions	139,540,777	13,955	139,554,732
Adjustment to general partner and limited partner split upon merger of predecessor partnerships	62,537	(62,537)	
<b>Balance, December 31, 2005</b>	\$ 156,466,172	\$ 15,648	\$ 156,481,820

See accompanying notes to consolidated financial statements.

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**HALLWOOD ENERGY, L.P. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<b>For the Years Ended December 31,</b>	
	<b>2005</b>	<b>2004</b>
		<b>(Unaudited)</b>
<b>Cash Flows from Operating Activities:</b>		
Net income (loss)	\$ 626,262	\$ (99,239)
Adjustments to reconcile net income (loss) to net cash provided by operating activities		
Depreciation and amortization	211,199	157,679
Loss on disposition of office equipment	208,801	
Gain from sale of undeveloped leaseholds	(2,751,090)	
Changes in assets and liabilities		
Accounts receivable and other assets	(41,582)	(326,165)
Accounts payable and accrued expenses	(372,250)	798,871
Advances from third parties	310,177	
Net cash provided by (used in) operating activities	(1,808,483)	531,146
<b>Cash Flows from Investing Activities:</b>		
Unproved, unevaluated leasehold costs	(53,347,004)	(3,174,886)
Purchase of office equipment	(148,021)	(749,566)
Proceeds from disposition of office equipment	98,950	
Gathering facilities additions	(8,009)	
Proceeds from the sale of undeveloped leaseholds	3,000,000	
Tubular inventory additions	(7,344,164)	
Transfers to restricted cash	(26,884)	(50,000)
Net cash used in investing activities	(57,775,132)	(3,974,452)
<b>Cash Flows from Financing Activities:</b>		
Partners' capital contributions	135,896,671	16,400,065
Change in liabilities		
Accounts payable to affiliate	(637,008)	637,008
Advances from limited partners	1,966,164	
Net cash provided by financing activities	137,225,827	17,037,073
<b>Increase in Cash and Cash Equivalents</b>	<b>\$ 77,642,212</b>	<b>\$ 13,593,767</b>
<b>Cash and Cash Equivalents, Beginning of Year</b>	<b>13,593,767</b>	
<b>Cash and Cash Equivalents, End of Year</b>	<b>\$ 91,235,979</b>	<b>\$ 13,593,767</b>

See accompanying notes to consolidated financial statements.





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**HALLWOOD ENERGY, L.P. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
YEARS ENDED DECEMBER 31, 2005 AND 2004 (unaudited)**

**1. ORGANIZATION AND NATURE OF OPERATIONS**

***Formation***

Hallwood Energy, L.P. ( Hallwood Energy or the Partnership ) is a privately held independent oil and gas limited partnership organized in the state of Delaware. On December 31, 2005, Hallwood Energy was formed from the consolidation of three privately held energy partnerships: Hallwood Energy II, L.P. ( HE II ), Hallwood Energy 4, L.P. ( HE 4 ) and Hallwood Exploration, L.P ( Hallwood Exploration ). The board of directors and management of the three partnerships recommended the consolidation because they believed it would simplify the structure and operations of the affiliated partnerships, align all the investors' interests, improve potential debt and financing opportunities, and facilitate future exit strategies. Following the completion of the consolidation, all energy activities are conducted by Hallwood Energy from its corporate office located in Dallas, Texas and a production office in Searcy, Arkansas.

***Principles of Consolidation***

Hallwood Energy fully consolidates all majority owned entities into its financial statements. All significant intercompany balances and transactions have been eliminated in consolidation. As of December 31, 2005, Hallwood Energy had two wholly owned subsidiaries:

Hallwood Petroleum, LLC ( HPL ) is a wholly owned subsidiary that serves as the drilling operations entity on behalf of Hallwood Energy. HPL is an administrative and management company to facilitate record keeping and processing; it has no financial value.

Hallwood Gathering, Inc. is also a wholly owned subsidiary holding pipelines and other related facilities to gather and transport production to market locations.

For presentation purposes, the consolidated financial statements for the years ended December 31, 2005 and 2004 include the combined activities of HE II, HE 4, and Hallwood Exploration. The consolidated financial statements are not indicative of the financial position and results of operations that might have occurred had the entities been combined and operated as a single entity during the periods presented. The consolidation was accounted for as a reorganization of entities under common control and common management. The consolidated financial statements reflect the historical costs of the combined entities.

***Operations***

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

Hallwood Energy has principally been acquiring unproved oil and gas leases in four geographical areas:  
the Barnett Shale formation in the Fort Worth Basin in North Texas,

the Barnett Shale and Woodford Shale formations in the Delaware Basin in West Texas,

a Salt Dome in South Louisiana, and

the Fayetteville Shale formation in East Arkansas.

In the future, Hallwood Energy will be involved in the drilling, gathering and sale of oil and natural gas in these areas.

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HALLWOOD ENERGY, L.P. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**2. SIGNIFICANT ACCOUNTING POLICIES**

As of December 31, 2005, the Partnership does not have any proven oil and gas reserves; however, management has established its accounting policies and some of the following discussions are for its future use.

***Use of Estimates***

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of certain assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during each reporting period. Management believes its estimates and assumptions will be reasonable; however, such estimates and assumptions will be subject to a number of risks and uncertainties, which may cause actual results to differ materially from the Partnership's estimates.

In the future, significant estimates underlying these financial statements will include the estimated quantities of proved oil and natural gas reserves used to compute depletion of natural gas properties and the related present value of estimated future net cash flows there from, estimates of production receivable based upon expectations for actual deliveries and prices received and the estimated fair value of asset retirement obligations. Oil and natural gas reserves, which are the basis for unit-of-production depletion and the ceiling test, have numerous inherent uncertainties. The accuracy of any reserve estimate is a function of the quality of available data and of engineering and geological interpretation and judgment. Results of drilling, testing and production subsequent to the date of the estimate may justify revision of such estimate. Accordingly, reserve estimates are often different from the quantities of oil and natural gas that are ultimately recovered. In addition, reserve estimates are vulnerable to changes in wellhead prices of crude oil and natural gas. Such prices have been volatile in the past and can be expected to be volatile in the future.

The significant estimates will be based on current assumptions that may be materially affected by changes to future economic conditions, such as the market prices received for sales of volumes of oil and natural gas. Future changes to these assumptions may affect these significant estimates materially in the near term.

***Property and Equipment***

Prior to December 2005, HE II, HE 4, and Hallwood Exploration acquired undeveloped leaseholds and did not engage in exploration and development activities.

The Partnership will follow the full cost method of accounting for oil and gas properties. Accordingly, all costs associated with the acquisition, exploration and development of oil and gas properties, including costs of undeveloped leasehold, geological and geophysical expenses, dry holes, leasehold equipment and overhead charges directly related to acquisition, exploration and development activities are or will be capitalized. There were no capitalized internal costs associated with acquisition, exploration and development activities for the year ended December 31, 2005.

Dispositions of oil and natural gas properties will be accounted for as adjustments to capitalized costs with no gain or loss recognized, unless such adjustments and proceeds are significant and would alter the relationship between capitalized costs and proved reserves.

The sum of net capitalized costs, including estimated costs to develop proved reserves and estimated dismantlement and abandonment costs, net of estimated salvage values, will be depleted on the equivalent unit-of-production method, based on proved oil and gas reserves as determined by independent petroleum engineers. Excluded from amounts subject to depletion are costs associated with the acquisition and evaluation

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HALLWOOD ENERGY, L.P. AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

of unproved properties. Such unproved properties will be assessed for impairment at least annually, and any impairment provision will be transferred to the full cost amortization base.

Net capitalized costs will be limited to the lower of unamortized cost net of deferred tax or the cost center ceiling. The cost center ceiling is defined as the sum of (i) estimated future net revenues, discounted at 10% per annum, from proved reserves, based on unescalated year-end prices and costs, adjusted for contract provisions; (ii) the cost of properties not being amortized; (iii) the lower of cost or market value of unproved properties included in the cost being amortized less; and (iv) income tax effects related to differences between the book and tax basis of the natural gas and crude oil properties.

Property and equipment, such as gathering systems and salt water disposal facilities, are or will be stated at original cost and depreciated using the straight-line method based on estimated useful lives from ten to fifteen years. Property and equipment, such as office furniture and equipment, are or will be stated at original cost and depreciated using the straight-line method based on estimated useful lives from three to five years.

***Asset Retirement Obligations***

In June 2001, the FASB issued Statement of Financial Accounting Standards ( SFAS ) No. 143, *Accounting for Asset Retirement Obligations*. SFAS No. 143 requires that an asset retirement obligation (ARO) associated with the retirement of a tangible long-lived asset be recognized as a liability in the period in which a legal obligation is incurred and becomes determinable, with an offsetting increase in the carrying amount of the associated asset. The cost of the tangible asset, including the initially recognized ARO, will be depleted such that the cost of the ARO is recognized over the useful life of the asset. The ARO will be recorded at fair value, and accretion expense will be recognized over time as the discounted liability is accreted to its expected settlement value. The fair value of the ARO will be measured using expected future cash outflows discounted at the company's credit-adjusted risk-free interest rate.

In accordance with the provisions of SFAS No. 143, the Partnership will record an abandonment liability associated with its oil and natural gas wells when those assets are placed in service.

Inherent in the fair value calculation of ARO are numerous assumptions and judgments including the ultimate settlement amounts, inflation factors, credit adjusted discount rates, timing of settlement, and changes in the legal, regulatory, environmental and political environments. To the extent future revisions to these assumptions impact the fair value of the existing ARO liability, a corresponding adjustment is made to the oil and natural gas property balance. Settlements greater than or less than amounts accrued with the ARO are recovered as a gain or loss upon settlement. The recording of these costs is anticipated to commence once wells are placed into service during 2006.

***Oil and Natural Gas Reserve Estimates***

The process of estimating quantities of proved reserves is inherently uncertain. Reserve engineering is a subjective process of estimating underground accumulations of hydrocarbons that cannot be measured in an exact manner. The process relies on interpretation of available geologic, geophysical, engineering and production data. The extent, quality and reliability of this data can vary. The process also requires certain economic assumptions, some of which are mandated, regarding drilling and operating expense, capital expenditures, taxes and availability of funds.

Proved reserve estimates prepared by others may be substantially higher or lower than the Partnership's estimates. Because these estimates depend on many assumptions, all of which may differ from actual results, reserve quantities actually recovered may be significantly different than estimated. Material revisions to reserve estimates may be made depending on the results of drilling, testing, and rates of production. One should not assume that the present value of future net cash flows is the current market value of the Partnership's estimated proved reserves.

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HALLWOOD ENERGY, L.P. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Partnership's rate of recording depreciation, depletion and amortization expense for proved properties will be dependent on the Partnership's estimate of proved reserves. If these reserve estimates decline, the rate at which the Partnership records these expenses will increase. The Partnership's full cost ceiling test will also depend on the Partnership's estimate of proved reserves. If these reserve estimates decline, the Partnership may be subjected to a full cost ceiling write-down.

***Cash and Cash Equivalents and Supplemental Cash Flow Information***

The Partnership considers highly liquid investments with original maturities of three months or less at the time of purchase to be cash equivalents. No cash was paid for interest or income taxes in 2005 or 2004.

***Supplemental disclosure of non-cash investing and financing activities***

As of December 31, 2005 and 2004, the Partnership had an accounts payable for unproved, unevaluated leasehold costs of \$5,154,863 and \$802,809, respectively.

During 2005, partners contributed \$3,658,061, at cost, of tubular inventory to the Partnership.

As of December 31, 2004, the Partnership had accounts payable of \$40,856 for equipment.

***Tubular Inventory***

Inventory consists of various sizes and types of oil field tubular pipes and casings, used in the ordinary course of the Partnership's drilling activities and is carried on a first in first out basis at the lower of cost or market.

***Revenue Recognition***

Revenues will be recognized when title to the products transfer to the purchaser. The Partnership will follow the sales method of accounting for its commodity revenue, so that the Partnership recognizes sales revenue on all commodities sold to its purchasers, regardless of whether the sales are proportionate to the Partnership's ownership in the property.

***Income Taxes***

Currently, Hallwood Energy is a non-taxable entity. Federal and state income taxes, if any, are the responsibility of the individual partners. Accordingly, the consolidated financial statements do not include a provision for income taxes. However, certain business and franchise taxes are the responsibility of Hallwood Energy and its subsidiaries. These business and franchise taxes, included in general and administrative expenses, were \$24,680 in 2005. Hallwood Energy's tax returns are subject to examination by federal and state taxing authorities. If Hallwood Energy's taxable income is ultimately changed by the taxing authorities, the tax liability of the partners could be changed accordingly.

***Disclosure of Fair Value of Financial Instruments***

The Partnership's financial instruments include cash, time deposits, accounts receivable and accounts payable. The carrying amounts reflected in the balance sheet for financial assets classified as current assets and the carrying amounts for financial liabilities classified as current liabilities approximate fair value due to the short maturity of such instruments.

***Derivative Instruments and Hedging Activities***

The Partnership has not entered into financial derivative instruments to hedge the price risk for the sale of its natural gas although the Partnership may, in the future, enter in to such financial instruments. The

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HALLWOOD ENERGY, L.P. AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Partnership will not enter into financial derivatives for trading or speculative purposes. The Partnership will sell some of its natural gas production under long-term contracts. These contracts qualify for the normal purchase and sale exception, and are not recognized at fair value.

All freestanding derivative financial instruments, including the derivative instruments embedded in other contracts if certain criteria are met, will be recognized at fair value on our balance sheet. Derivative instruments that are not recognized as hedges must be adjusted to fair value through the statement of operations. Changes in the fair value of derivative instruments that are designated as cash-flow hedges are deferred in other comprehensive operations until such time that the hedged items are recognized in operations. The ineffective portion of a change in value of a derivative instrument is recognized in operations immediately.

***Credit Risk***

Credit risk is the risk of loss as a result of nonperformance by counterparties of their contractual obligations. The Partnership had no production during 2005, but is currently reviewing markets and alternatives for production expected in early 2006. The Partnership monitors its exposure to counterparties by reviewing credit ratings, financial statements and credit service reports. Each customer and/or counterparty of the Partnership is reviewed as to credit worthiness prior to the extension of credit and on a regular basis thereafter. Further assurances including, but not limited to Letters of Credit are required as necessary. In this manner, the Partnership reduces credit risk.

***New Accounting Pronouncement***

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets*, an amendment of APB No. 29. This Statement amends Opinion 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. The Statement specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. This Statement is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. Earlier application is permitted for nonmonetary asset exchanges occurring in fiscal periods beginning after the date this Statement is issued. Retroactive application is not permitted. Management has determined that adoption of SFAS No. 153 did not have any impact on the Partnership's financial position, results of operations or cash flow, but will be applied on any future exchanges.

***Segment Reporting***

Operating segments are defined as components of an entity for which separate financial information is available that is evaluated by the chief operating decision-makers in deciding how to allocate resources and in assessing performance. Management believes that Hallwood Energy operates in only one business segment, energy.

***Letter of Credit***

As required by the State of Texas, the Partnership issued a \$50,000 letter of credit to the Railroad Commission of Texas in conjunction with its intentions to engage in oil and natural gas drilling, or producing activities. The letter of credit is renewed annually.

**3. PARTNERS CAPITAL**

Partners' capital (including allocation of income and loss, cash contributions and distributions) is allocated 99.99% to limited partners and 0.01% to the general partner. See Note 5 for information about the general partner and related parties.

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HALLWOOD ENERGY, L.P. AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In December 2005, Hallwood Energy solicited an equity cash call totaling \$90,000,000 from its partners to fund the 2006 capital drilling program, of which \$9,197,607 remained uncollected as of December 31, 2005. The funds were received in January 2006 and partners' capital increased accordingly.

**4. GAIN FROM SALE OF UNDEVELOPED LEASEHOLDS**

On July 18, 2005, HE II completed a purchase and sale agreement with Chesapeake Energy Corporation that included undeveloped leaseholds in Johnson County, Texas for \$3,000,000. The sale was consideration in exchange for 66 individual leases covering 863 gross (835 net) acres with a cost basis of \$249,000, yielding a gain on sale of \$2,751,000.

**5. RELATED PARTY TRANSACTIONS**

The general partner is Hallwood Energy Management, LLC (HEM). HEM is owned equally by three entities: The Hallwood Group Incorporated (Hallwood), Hall Performance Energy Partners 4, LTD., and Fayetteville Shale, LP.

Hallwood is a Delaware corporation formed in September 1981 and is publicly traded on the American Stock Exchange under the ticker symbol HWG. Hallwood is a holding company that operates in the textile products and energy business segments.

Two directors and officers of HEM are also directors or officers of Hallwood, which holds 26% (22% after consideration of profits interests) of the Class A Limited Partnership Interests in the Partnership and as previously mentioned 33% interest in the general partner, HEM. In addition, certain officers and directors of Hallwood are investors in the Partnership and, as members of management of the Partnership, one director and officer and one officer of Hallwood hold a profit interest in the Partnership. Each of these individuals held similar positions with the general partners of the predecessor entities and held interests in the predecessor entities.

Beginning August 1, 2005, Hallwood Energy and its predecessor entities share leased office space, facilities and certain staff with Hallwood in Dallas, Texas. Hallwood Energy reimburses Hallwood for its allocable share of such expenses. For the five month period ended December 31, 2005, Hallwood Energy reimbursed Hallwood \$59,000 for such expenses.

In 2005, HPL, a wholly-owned subsidiary of Hallwood Energy, entered into a financial consulting contract with Anthony J. Gumbiner. The contract provides that he furnish and perform consulting and advisory services to the Partnership and its subsidiaries, including strategic planning and merger activities, for an annual compensation of \$200,000. Mr. Gumbiner is chairman and chief executive officer of both Hallwood and Hallwood Energy, as well as a limited partner of Hallwood Energy.

As of December 31, 2005, the Partnership held \$1,966,164 of funds from certain limited partners which will be applied to future solicitations for equity cash calls.

**6. SUBSEQUENT EVENTS (unaudited)*****Loan Facility***

In February 2006, the Partnership entered into a \$65,000,000 loan facility. As of March 1, 2006, the Partnership has drawn \$40,000,000 from this facility, principally to acquire oil and gas leases and fund exploration and drilling activities. It is anticipated that the facility will be fully drawn by June 2006. The loan is secured by the Partnership's oil and gas leases, matures on June 30, 2007 and has an interest rate of LIBOR plus 8.75% per annum (13.39% as of March 1, 2006). An additional 2% of interest is added upon continuance of any defaulting event. The loan requires an asset to borrowing limit ratio of 1.25 to 1 and audited financial statements. The Partnership may not re-borrow any amounts that are prepaid before the loan's maturity.

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HALLWOOD ENERGY, L.P. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Additionally, there is a draw fee equal to 1.5% for each borrowing, a one-year anniversary fee equal to 2% of the outstanding balance, and a non-usage fee of 0.5% per annum of the average available commitment.

***Leasehold Costs and Capital Expenditures for 2006***

During the first quarter of 2006, the Partnership has significantly increased its undeveloped leasehold position in East Arkansas by approximately \$84,000,000, increasing its total leasehold investment in East Arkansas to approximately \$124,000,000 as of March 31, 2006. The leasehold costs were funded by the aforementioned \$40,000,000 draw from the loan facility and from cash on hand as of December 31, 2005.

For the remainder of 2006, additional capital expenditures are anticipated to be funded by conventional debt, secured by reserves which may become proven and producing, as well as from additional partner capital contributions, which may total an additional \$50,000,000.



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

<b>Exhibit Number</b>	<b>Description</b>
10.21	Limited Partnership Agreement of Hallwood Energy 4, L.P., a Delaware Limited Partnership, dated as of August 23, 2005; Memorandum of Amendment Changing the Name of Hallwood Energy 4, L.P. to Hallwood Energy, L.P., effective immediately before midnight on December 31, 2005; and Amendment to Limited Partnership Agreement of Hallwood Energy, L.P. dated as of December 31, 2005
10.22	Second Amendment to Second Amended and Restated Revolving Credit Loan and Security Agreement, dated as of March 25, 2006, by and among Key Bank National Association, Brookwood Companies Incorporated and certain subsidiaries.
21	Active subsidiaries of the Registrant as of February 28, 2006
23.1	Independent Registered Public Accounting Firm's Consent, dated April 11, 2006
31.1	Certification of the Chief Executive Officer, pursuant to Section 302 of Sarbanes-Oxley Act of 2002
31.2	Certification of the Chief Financial Officer, pursuant to Section 302 of Sarbanes-Oxley Act of 2002
32.1	Certification of the Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002