HALLWOOD GROUP INC
Form 10-Q
August 14, 2008

Table of Contents

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

**Form 10-Q**

MARK ONE

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

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

**FOR THE TRANSITION PERIOD FROM _________ TO _________**

**For the Period Ended June 30, 2008**

**Commission File Number: 1-8303**

**The Hallwood Group Incorporated**

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **Delaware** | **51-0261339** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification Number) |
| **3710 Rawlins, Suite 1500, Dallas, Texas** | **75219** |
| (Address of principal executive offices) | (Zip Code) |

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

**Securities Registered Pursuant to Section 12(b) of the Act:**

| **Title of Class** | **Name of Each Exchange On Which Registered** |
|---|---|
| Common Stock ($0.10 par value) | American Stock Exchange |

**Securities Registered Pursuant to Section 12(g) of the Act:**

**<u>Title of Class</u>**

Series B Redeemable Preferred Stock

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES þ NO o

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

| | | | |
|---|---|---|---|
| Large accelerated filer o | Accelerated filer o | Non-accelerated filer o (Do not check if a smaller reporting company) | Smaller reporting company þ |

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

The aggregate market value of the Common Stock held by non-affiliates of the registrant as of June 30, 2008, based on the closing price of $67.15 per share on the American Stock Exchange, was $32,865,000.

1,520,666 shares of Common Stock were outstanding at July 31, 2008.

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

Table of Contents

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

| | June 30, 2008 | December 31, 2007 |
|---|---|---|
| **ASSETS** | | |
| **Current Assets** | | |
| Cash and cash equivalents | $ 5,926 | $ 7,260 |
| Accounts receivable, net | | |
| Due from factors | 23,817 | 20,340 |
| Trade and other | 6,016 | 5,521 |
| Related parties | 151 | 249 |
| Inventories, net | 22,811 | 25,028 |
| Federal income tax receivable | 12,239 | 12,239 |
| Deferred income tax, net | 971 | 971 |
| Prepaids, deposits and other assets | 521 | 928 |
| | 72,452 | 72,536 |
| **Noncurrent Assets** | | |
| Investments in Hallwood Energy, net | | |
| Property, plant and equipment, net | 14,540 | 14,443 |
| Deferred income tax, net | 3,508 | 3,629 |
| Other assets | 133 | 137 |
| | 18,181 | 18,209 |
| **Total Assets** | $ 90,633 | $ 90,745 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| **Current Liabilities** | | |
| Accounts payable | $ 12,417 | 13,602 |
| Guarantee obligation additional investment in Hallwood Energy | 7,290 | |
| Accrued expenses and other current liabilities | 5,161 | 4,952 |
| State income taxes payable | 376 | 13 |
| Current portion of loans payable | 93 | 158 |
| Payable additional investment in Hallwood Energy | | 5,000 |
| | 25,337 | 23,725 |
| **Noncurrent Liabilities** | | |

| | | |
|---|---|---|
| Long term portion of loans payable | 15,248 | 17,208 |
| Redeemable preferred stock | 1,000 | 1,000 |
| | 16,248 | 18,208 |
| **Total Liabilities** | 41,585 | 41,933 |
| **Stockholders Equity** | | |
| Common stock, issued 2,396,105 shares for both periods; outstanding 1,520,666 shares for both periods | 240 | 240 |
| Additional paid-in capital | 56,469 | 56,469 |
| Retained earnings | 5,812 | 5,576 |
| Treasury stock, 875,439 shares for both periods; at cost | (13,473) | (13,473) |
| **Total Stockholders Equity** | 49,048 | 48,812 |
| **Total Liabilities and Stockholders Equity** | $ 90,633 | $ 90,745 |

See accompanying notes to condensed consolidated financial statements.

Page 3

Table of Contents

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

| | Six Months Ended June 30, 2008 | Six Months Ended June 30, 2007 |
|---|---|---|
| **Revenues** | | |
| Textile products sales | $ 91,121 | $ 60,373 |
| **Expenses** | | |
| Textile products cost of sales | 66,519 | 50,247 |
| Administrative and selling expenses | 10,766 | 9,331 |
| | 77,285 | 59,578 |
| Operating income | 13,836 | 795 |
| **Other Income (Loss)** | | |
| Investments in Hallwood Energy | | |
| Equity loss | (12,120) | (12,376) |
| Interest income | | 92 |
| Interest expense | (428) | (509) |
| Interest and other income | 42 | 236 |
| | (12,506) | (12,557) |
| Income (loss) before income taxes | 1,330 | (11,762) |
| Income tax expense (benefit) | 1,094 | (3,865) |
| **Net Income (Loss)** | $ 236 | $ (7,897) |
| **Net Income (Loss) Per Common Share** | | |
| Basic | $ 0.16 | $ (5.21) |
| Diluted | $ 0.15 | $ (5.21) |
| **Weighted Average Shares Outstanding** | | |
| Basic | 1,521 | 1,517 |

| | | |
|---|---|---|
| Diluted | 1,523 | 1,517 |

See accompanying notes to condensed consolidated financial statements.

Table of Contents

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

| | Three Months Ended June 30, 2008 | Three Months Ended June 30, 2007 |
|---|---|---|
| **Revenues** | | |
| Textile products sales | $ 47,134 | $ 32,065 |
| **Expenses** | | |
| Textile products cost of sales | 33,967 | 25,958 |
| Administrative and selling expenses | 5,553 | 4,727 |
| | 39,520 | 30,685 |
| Operating income | 7,614 | 1,380 |
| **Other Income (Loss)** | | |
| Investments in Hallwood Energy | | |
| Equity loss | (9,159) | (1,873) |
| Interest income | | 80 |
| Interest expense | (181) | (283) |
| Interest and other income | 24 | 55 |
| | (9,316) | (2,021) |
| Income (loss) before income taxes | (1,702) | (641) |
| Income tax expense (benefit) | (372) | (68) |
| **Net Income (Loss)** | $ (1,330) | $ (573) |
| **Net Income (Loss) Per Common Share** | | |
| Basic | $ (0.87) | $ (0.38) |
| Diluted | $ (0.87) | $ (0.38) |
| **Weighted Average Shares Outstanding** | | |
| Basic | 1,521 | 1,517 |

| | | |
|---|---|---|
| Diluted | 1,521 | 1,517 |

See accompanying notes to condensed consolidated financial statements.

**Table of Contents**

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2008** | **2007** | **2008** | **2007** |
| **Net Income (Loss)** | $ (1,330) | $ (573) | $ 236 | $ (7,897) |
| Other Comprehensive Income (Loss) | | | | |
| Previously realized increase in fair value of marketable securities sold during the period | | | | (55) |
| **Comprehensive Income (Loss)** | $ (1,330) | $ (573) | $ 236 | $ (7,952)) |

See accompanying notes to condensed consolidated financial statements.

**Table of Contents**

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

| | Common Stock | | Additional Paid-In | Retained | Treasury Stock | | Total Stockholders |
|---|---|---|---|---|---|---|---|
| | Shares | Par Value | Capital | Earnings | Shares | Cost | Equity |
| **Balance, January 1, 2008** | 2,396 | $ 240 | $ 56,469 | $ 5,576 | 875 | $ (13,473) | $ 48,812 |
| Net income | | | | 236 | | | 236 |
| **Balance, June 30, 2008** | 2,396 | $ 240 | $ 56,469 | $ 5,812 | 875 | $ (13,473) | $ 49,048 |

See accompanying notes to condensed consolidated financial statements.

Table of Contents

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

| | Six Months Ended June 30, 2008 | Six Months Ended June 30, 2007 |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | |
| Net income (loss) | $ 236 | $ (7,897) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | |
| Equity loss from investments in Hallwood Energy | 12,120 | 12,376 |
| Depreciation and amortization | 1,156 | 904 |
| Deferred tax expense (benefit) | 121 | (4,133) |
| Excess tax benefits from share-based payment arrangements | | (275) |
| Proceeds from sale of marketable securities | | 148 |
| Income from investments in marketable securities | | (74) |
| Changes in assets and liabilities: | | |
| (Increase) decrease in accounts receivable | (3,874) | (3,321) |
| (Increase) decrease in inventories | 2,217 | (2,415) |
| Increase (decrease) in accounts payable | (891) | 2,011 |
| Increase in income taxes receivable/payable | 444 | 1,099 |
| Increase (decrease) in accrued expenses and other current liabilities | 209 | 621 |
| Net change in other assets and liabilities | 330 | 12 |
| Net cash provided by (used in) operating activities | 12,068 | (944) |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | |
| Investments in Hallwood Energy | (9,830) | (9,247) |
| Investments in property, plant and equipment, net | (1,547) | (721) |
| Net cash used in investing activities | (11,377) | (9,968) |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | |
| Repayment of other bank borrowings and loans payable | (2,025) | (152) |
| Proceeds from revolving credit facilities, net | | 4,164 |
| Purchase of common stock for treasury | | (439) |
| Excess tax benefits from share-based payment arrangements | | 275 |
| Proceeds from exercise of stock options | | 165 |
| Net cash provided by (used in) financing activities | (2,025) | 4,013 |
| **DECREASE IN CASH AND CASH EQUIVALENTS** | (1,334) | (6,899) |

| | | |
|---|---|---|
| **CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD** | 7,260 | 10,054 |
| **CASH AND CASH EQUIVALENTS, END OF PERIOD** | $ 5,926 | $ 3,155 |

See accompanying notes to condensed consolidated financial statements.

Table of Contents

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**
**Six Months Ended June 30, 2008 and 2007**
**(unaudited)**

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

*Interim Condensed Consolidated Financial Statements*. The interim condensed consolidated financial statements of The Hallwood Group Incorporated and its subsidiaries (the Company ) (AMEX: HWG), a Delaware corporation, have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and disclosures required by accounting principles generally accepted in the United States of America. Although condensed, in the opinion of management, all adjustments considered necessary for a fair presentation have been included. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related disclosures thereto included in Form 10-K for the year ended December 31, 2007.

*Organization.* The Company is a holding company with interests in textile products and energy.

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

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

Brookwood Laminating Incorporated ( Brookwood Laminating ). Brookwood Laminating, located in Connecticut, 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 seven layers of textile materials can be processed using both wet and dry lamination techniques.

Strategic Technical Alliance, LLC ( STA ). STA is part of the Brookwood Marketing division and markets advanced breathable, waterproof laminate and other fabrics primarily for military applications. Continued development of these fabrics for military applications is a key element of Brookwood s business plan. STA s operations are gradually being transferred directly to Brookwood.

Textile products accounts for all of the Company s operating revenues. See Note 3 for additional information on Brookwood.

*Energy.* Effective December 31, 2005, the Company s remaining energy affiliates, Hallwood Energy II, L.P. ( HE II ), Hallwood Energy 4, L.P. ( HE 4 ) and Hallwood Exploration, L.P. ( Hallwood Exploration ), were consolidated into HE 4, which was renamed Hallwood Energy, L.P. ( Hallwood Energy ). The Company accounted for the former investments using the equity method of accounting. At the consolidation date, Hallwood Energy was principally involved in acquiring oil and gas leases and drilling, gathering and sale of natural gas in the Barnett Shale formation located in Parker, Hood and Tarrant Counties in North Texas, the Barnett Shale and Woodford Shale formations in West Texas, in the Fayetteville Shale formation of Central Eastern Arkansas, and conducting 3-D seismic surveys over optioned land covering a Salt Dome in South Louisiana in order to determine how best to proceed with exploratory activity.

All of the Company s energy activities are conducted through Hallwood Energy. The Company accounts for Hallwood Energy using the equity method of accounting. See Note 4 for additional information on Hallwood Energy.

*New Accounting Pronouncements.* In September 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 157, *Fair Value Measurements* . This Statement defines fair value as used in numerous accounting pronouncements, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosure related to the use of fair value measures in financial statements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The adoption of SFAS No. 157 did not have a material impact on the Company s financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115.* SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The FASB believes the statement will improve financial reporting by providing companies the opportunity to mitigate volatility in reported earnings by measuring related assets and liabilities differently without



---

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**
**Six Months Ended June 30, 2008 and 2007**
**(unaudited)**

having to apply complex hedge accounting provisions. Use of the statement will expand the use of fair value measurements for accounting for financial instruments. Although the Company has not yet elected to present any financial assets or liabilities at fair value under SFAS No. 159, it may choose to do so in the future.

The Emerging Issues Task Force ( EITF ) of the FASB ratified EITF Issue 06-11, *Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards* ( EITF 06-11 ) in June 2007. In a stock-based compensation arrangement, employees may be entitled to dividends during the vesting period for nonvested shares or share units and until the exercise date for stock options. These dividend payments generally can be treated as a deductible compensation expense for income tax purposes, thereby generating an income tax benefit for the employer. At issue was how such a realized benefit should be recognized in the financial statements. The EITF has reached a conclusion that an entity should recognize the realized tax benefit as an increase in additional paid-in capital ( APIC ) and that the amount recognized in APIC should be included in the pool of excess tax benefits available to absorb tax deficiencies on stock-based payment awards. EITF 06-11 will be effective prospectively for the income tax benefits that result from dividends on equity-classified employee share-based payment awards that are declared in fiscal years beginning after December 15, 2007. The adoption of this EITF did not have a material impact on the Company s financial statements.

On May 9, 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* . This statement identifies a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with U.S. generally accepted accounting principles for nongovernmental entities. It establishes that the GAAP hierarchy should be directed to entities because it is the entity (not the auditor) that is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP. SFAS No. 162 is effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board auditing amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. Management does not believe that implementation of SFAS No. 162 will have any effect on the Company s consolidated financial statements.

**Note 2 Inventories**

Inventories, all of which relate to Brookwood, as of the balance sheet dates were as follows (in thousands):

| | June 30, 2008 | December 31, 2007 |
|---|---|---|
| Raw materials | $ 6,638 | $ 8,084 |
| Work in progress | 8,130 | 8,218 |
| Finished goods | 9,131 | 9,475 |
| | 23,899 | 25,777 |
| Less: Obsolescence reserve | (1,088) | (749) |
| Total | $ 22,811 | $ 25,028 |

**Note 3 Operations of Brookwood Companies Incorporated**

*Receivables.* Brookwood maintains factoring agreements with several factors, 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 and the factor s prior approval.

One of Brookwood s factors announced in March 2008 that it had been negatively impacted by the tightening in the credit markets and was required to draw on its bank credit lines to provide additional liquidity. The factor announced in June 2008 that it acquired additional financing to strengthen its balance sheet and improve and diversify its liquidity and funding. Brookwood is monitoring its factor relationships and developing alternative strategies should economic conditions deteriorate further. As of August 1, 2008, all of Brookwood s factors were complying with payment terms in accordance with factor agreements.

*Sales Concentration.* Sales to one Brookwood customer, Tennier Industries, Inc. ( Tennier ), accounted for more than 10% of Brookwood s sales during both the 2008 and 2007 three month and six month periods. Its relationship with Tennier is ongoing. Sales to Tennier, which are included in military sales, were $15,112,000 and $29,980,000 in the 2008 second quarter and six

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**
**Six Months Ended June 30, 2008 and 2007**
**(unaudited)**

month periods, respectively, compared to $8,675,000 and $15,570,000 in 2007. Sales to Tennier represented 32.1% and 27.1% of Brookwood s net sales in the 2008 and 2007 second quarters, respectively, and 32.9% and 25.8% in the 2008 and 2007 six month periods, respectively. Sales to another customer, ORC Industries, Inc. ( ORC ), accounted for more than 10% of Brookwood s sales in 2008. Its relationship with ORC is ongoing. Sales to ORC, which are included in military sales, were $5,252,000 and $9,281,000 in the 2008 second quarter and six month periods, respectively, compared to $2,024,000 and $4,230,000 in 2007. Sales to ORC represented 11.1% and 6.3% of Brookwood s net sales in the 2008 and 2007 second quarters, respectively, and 10.2% and 7.0% in the 2008 and 2007 six month periods, respectively.

Military sales accounted for $31,981,000 and $60,139,000 in the 2008 second quarters and six month periods, respectively, compared to $16,656,000 and $28,692,000 in 2007. The military sales represented 67.9% and 51.9% of Brookwood s net sales in the 2008 and 2007 quarters, respectively, and 66.0% and 47.5% in the 2008 and 2007 six month periods, respectively.

*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 June 30, 2008, cumulative dividends in arrears on the preferred stock amounted to approximately $664,000.

*2005 Long-Term Incentive Plan for Brookwood.* In December 2005, the Company adopted The Hallwood Group Incorporated 2005 Long-Term Incentive Plan for Brookwood Companies Incorporated (the 2005 Long-Term Incentive Plan for Brookwood ) to encourage employees of Brookwood to increase the value of Brookwood and to be employed by 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 $14,164,000 at June 30, 2008). 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. However, if the Company s board of directors determines that certain specified Brookwood officers, or other persons performing similar functions do not have, prior to the change of control transaction, in the aggregate an equity or debt interest of at lease two percent in the entity with whom the change of control transaction is completed, then the minimum amount to be awarded under the plan shall be $2,000,000. In addition, the Company agreed that, if members of Brookwood s 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.

*Engagement of Financial Advisor.* In December 2007, a special committee of the board of directors of the Company engaged a financial advisor to assist it in developing strategic alternatives, including a potential sale, with respect to Brookwood. This initiative is continuing, but there can be no assurance that the special committee will recommend any action with respect to Brookwood or that any transaction will be completed.

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATE**