HALLWOOD GROUP INC
Form 10-K
May 14, 2007

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

MARK ONE

þ	**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM TO**

For the Year Ended December 31, 2006 **Commission File Number: 1-8303**

The Hallwood Group Incorporated
(Exact name of registrant as specified in its charter)

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

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

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

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

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

Title of Class

Series B Redeemable Preferred Stock

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

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

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

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

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

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

The aggregate market value of the Common Stock, $0.10 par value per share, held by non-affiliates of the registrant as of June 30, 2006, based on the closing price of $112.53 per share on the American Stock Exchange, was $55,075,000.

1,516,711 shares of Common Stock, $0.10 par value per share, were outstanding at March 23, 2007.

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.

THE HALLWOOD GROUP INCORPORATED

FORM 10-K

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PART I

Item 1. *Business*

The Hallwood Group Incorporated (Hallwood or the Company) (AMEX:HWG), a Delaware corporation formed in September 1981, is a holding company with interests in textile products and energy. 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 subsidiary, Brookwood Companies Incorporated (Brookwood). Brookwood is an integrated textile firm that develops and produces innovative fabrics and related products through specialized finishing, treating and coating processes.

Brookwood operates as a converter in the textile industry, purchasing fabric from mills that is dyed, 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 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 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 seven layers of textile materials can be processed using both wet and dry lamination techniques. Brookwood Laminating entered into a lease for production and warehouse space in Connecticut and relocated from its former 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 and styles, including Cordura nylon in solid colors as well as military prints, supplex nylon, high visibility ansi compliant polyesters, waterproof breathable laminates, polyester microfibers and coated polyester fabrics. As speed is essential in this area, Brookwood Roll Goods has positioned its sales and distribution facilities in southern California and Connecticut 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 relocated their Rhode Island operations during 2006 and share a portion of the Connecticut facility.

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 base level 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.

In January 2003, Brookwood was granted a patent, which expires in September 2019, 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.

The textile products segment accounts for substantially all of the Company s operating revenues. For details regarding revenue, profit and total assets, see Note 21 to the Company s consolidated financial statements.

Energy. Following the sale of Hallwood Energy III, L.P. (HE III) in July 2005, the Company s remaining affiliates were Hallwood Energy II, L.P. (HE II), Hallwood Energy 4, L.P. (HE 4) and Hallwood Exploration, L.P. (Hallwood Exploration). At that time, the Company owned between 20% and 26% of the entities (between 17% and 21% on a fully diluted basis) and accounted for the investments using the equity method of accounting, recording its pro rata share of net income (loss), partners capital transactions and comprehensive income (loss). These private companies were principally involved in acquiring oil and gas leases and drilling, gathering and sale of natural gas in the Barnett Shale formation of Parker, Hood and Tarrant Counties in North Texas, the Barnett Shale and Woodford Shale formations in West Texas, the Fayetteville Shale formation in 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.

Effective December 31, 2005, HE II and Hallwood Exploration were consolidated into HE 4, which was renamed Hallwood Energy, L.P. (Hallwood Energy). The Company owned approximately 26% (22% after consideration of profits interests) of Hallwood Energy at that date. All energy activities are now conducted by Hallwood Energy.

Hallwood Energy is an upstream energy partnership engaging in the acquisition, development, exploration, production, and sale of hydrocarbons, with a primary focus on natural gas assets. Hallwood Energy had no proved reserves at December 31, 2006. Hallwood Energy s results of operations are and 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.

The partners capital interests in Hallwood Energy were proportionate to the capital invested in each of the consolidated entities. 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
Accumulated equity loss	(106)
Total	$ 40,854

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

Energy Corporation (Chesapeake), which became the operator of these properties.

As of December 31, 2006, the Company owned 25% (20% after consideration of profit interests) of Hallwood Energy. Hallwood Energy s management has classified its energy investments into three identifiable areas: Central Eastern Arkansas, South Louisiana and West Texas.

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. For details regarding revenue, profit (or loss) and total assets, see Note 21 to the Company s consolidated financial statements.

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Discontinued Operations

Real Estate. The Company s former 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.

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 obligation.

Number of Employees

The Company had 447 and 462 employees as of February 28, 2007 and 2006, respectively, comprised as follows:

	February 28,	
	2007	**2006**
Hallwood	11	10
Brookwood	436	452
Total	447	462

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, 2007. Management believes that overall relations with employees are good.

Available Information

The Company s Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to reports filed pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended (the Exchange Act), are available on its website at www.hallwood.com, as soon as 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.

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Executive Officers of the Company

In addition to Anthony J. Gumbiner, age 62, 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 63, 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 Hallwood Energy and each of the former 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 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, 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 64, 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 is a member of the American Institute of Certified Public Accountants and of the Ohio Society of Certified Public Accountants.

Amber M. Brookman, age 65, 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 1A. *Risk Factors*

Risks Related to the Company

Influence of Significant Stockholder. The Company s chairman and chief executive officer, Mr. Anthony J. Gumbiner, owns approximately 66.0% of the Company s outstanding common stock (65.5% on a fully diluted basis) as of March 23, 2007. 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.

Risks Related to Our Textile Products Business

The Company s textile products business may be affected by the following risk factors, each of which could adversely affect the Company.

Suppliers. 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. Sales to one Brookwood customer, Tennier Industries, Inc. (Tennier), accounted for more than 10% of Brookwood s sales in each of the three years ended December 31, 2006. Its relationship with Tennier is ongoing. Sales to Tennier, which are included in military sales, were $31,300,000, $56,883,000 and $53,149,000 in 2006, 2005 and 2004, respectively, which represented 27.9%, 42.7% and 39.0% of Brookwood s sales. Sales to another customer, ORC Industries, Inc. (ORC), have increased in 2006 and accounted for more than 10% of Brookwood s sales. Its relationship with ORC is ongoing. Sales to ORC, which are also included in military sales, were $12,609,000, $10,099,000 and $13,229,000 in 2006, 2005 and 2004, respectively, which represented 11.2%, 7.6% and 9.7% of Brookwood s sales.

Through 2005, military sales, including the sales to Tennier and ORC, generally comprised an increased portion of Brookwood s total sales and a greater share of gross profit. However, Brookwood experienced reduced military sales in 2006. Military sales were $53,885,000, $72,456,000 and $75,899,000 in 2006, 2005 and 2004, respectively, which represented 48.0%, 54.4% and 55.7% of Brookwood s sales. 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 limited orders for existing products and adopted 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 a continuing challenge to adjust to changing specifications and production requirements. Brookwood is currently conducting research and development on various processes and products intended to comply with the revised specifications and participating in the bidding process for new military products. The U.S. government has recently released orders for goods that include Brookwood s products. However, to the extent Brookwood s products are not included in future purchases by the U.S. government for any reason, Brookwood s sales could be adversely affected. 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, 2006 and for all interim periods during 2006.

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. 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. As a result, 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, military or industrial preferences and general economic conditions affecting the textile and apparel industries, such as consumer expenditures for non-durable goods. The textile and apparel industries are also cyclical because the supply of particular products changes as competitors enter or leave the market.

Brookwood sells primarily to domestic manufacturers, some of which operate offshore sewing operations. Some of Brookwood s customers have moved their business offshore during the past few years. Brookwood has responded by shipping fabric 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. Notwithstanding quota elimination, China s accession agreement for membership in the WTO provides that WTO member countries (including the United States, Canada and European countries) may re-impose quotas on specific categories of products in the event it is determined that imports from China have surged and are threatening to create a market disruption for such categories of products. During 2005, the United States and China agreed to a new quota arrangement, which will impose quotas on certain textile products through the end of 2008. In addition, the European Union also agreed with China on a new textile

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arrangement, which imposed quotas through the end of 2007. The United States may also unilaterally impose additional duties in response to a particular product being imported (from China or other countries) in such increased quantities as to cause (or threaten) serious damage to the relevant domestic industry (generally known as anti-dumping actions). In addition, China has imposed an export tax on all textile products manufactured in China; we do not believe this tax will have a material impact on our business.

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. 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 and other 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; 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 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, 2007. Management believes that overall relations with employees are good.

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, the loss of their services could adversely affect Brookwood s operations.

Risks Related to Our Energy Business

The Company s energy investment 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 Hallwood Energy affiliate.

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 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, Hallwood Energy 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 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.

Quantity and Present Value of Reserves. Financial information for Hallwood Energy 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.

Loan Covenants. In April 2007, Hallwood Energy entered into a $100,000,000 senior secured credit facility with an affiliate of one of the investors. The facility contains various financial covenants, including maximum general and administrative expenditures and current and proved collateral coverage ratios. The initial proved collateral coverage ratio test is performed June 30, 2008, and each quarter thereafter. Non-financial covenants restrict the ability of Hallwood Energy to dispose of assets, incur additional indebtedness, prepay other indebtedness or amend certain debt instruments, pay dividends, create liens on assets, enter into sale and leaseback transactions, make investments, loans or advances, make acquisitions, engage in mergers or consolidations or engage in certain transactions with affiliates, and otherwise restrict certain activities by Hallwood Energy. The new lender may demand that Hallwood Energy prepay the outstanding loans in the event of a defined change of control, qualified sale or event of default, including a material adverse event.

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The facility contains a make-whole provision whereby Hallwood Energy is required to pay the lender the amount by which the present value of interest and principal payable from the date of prepayment through January 31, 2009, exceeds the principal amount at the prepayment date.

Item 1B. ***Unresolved Staff Comments***

None.

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, 2006 (in thousands):

Property Type	**Location**	**Cost**
Dyeing and finishing plant	Rhode Island	$ 5,861
Parking Lot	Texas	50
Total		$ 5,911

As of December 31, 2006, 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. The plant is pledged as collateral under Brookwood s Key Bank Credit Agreement, which also 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 leased its former corporate headquarters in New York City, which expired in August 2006. In 2006, Brookwood entered into a lease which commenced in August 2006 for the relocation of its headquarters to another location within New York City. This ten-year lease expires in August 2016 and provides for additional marketing and administrative space.

Brookwood Laminating leased a facility in Peacedale, Rhode Island which expired in December 2006. In January 2006, Brookwood Laminating entered into a lease for a new facility in Plainfield, Connecticut which expires in December 2010. This lease has a five-year renewal option and a purchase option. The relocation occurred gradually during 2006 and was completed in December 2006. The Brookwood Roll Goods and First Performance Fabrics divisions relocated their Rhode Island operations during 2006 and share a portion of the new Brookwood Laminating facility in Connecticut.

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

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Item 3. *Legal Proceedings*

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

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.

Hallwood Energy. As a significant investor in Hallwood Energy, the Company may be impacted by litigation involving Hallwood Energy. Refer to Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations Investments in Energy Affiliates for a further description of certain litigation involving Hallwood Energy.

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

In August 2005, the Rhode Island Department of Health (RIDOH) issued a compliance order to 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, Kenyon received a Notice of Alleged Violation from The Rhode Island Department of Environmental Management (RIDEM) with notification that Kenyon 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, Kenyon has upgraded and retested the equipment, which met the requirements on the retest. RIDEM has requested additional information regarding the failed test and Kenyon s remedial actions, which Kenyon has provided. In February 2007, RIDEM issued a Notice of Violation (NOV) accompanied by a $14,000 fine. Kenyon, requested an informal hearing to dispute the allegations in the NOV and the fine. As a result of the informal hearing held on March 30, 2007, a consent agreement was executed and a $9,500 fine was remitted to RIDEM to close this matter.

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 accrued an additional $35,000 for remediation costs in 2006. Brookwood received approval from RIDEM for the remediation activities, which were completed in July 2006.

In October 2005, Brookwood Laminating received a 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 contested the NOV and in January 2006, settled the matter with a reduced penalty in the amount of $12,750.

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

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

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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 584 stockholders of record as of March 23, 2007.

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,					
	2006			2005		
Quarters	**High**	**Low**	**Dividends**	**High**	**Low**	**Dividends**
First	$ 152.00	$ 69.91	$	$ 141.98	$ 99.25	$
Second	141.00	80.75		159.00	73.00	37.70
Third	121.00	94.00		90.00	61.00	6.17
Fourth	122.50	80.50		81.00	56.50	

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 two cash distributions were 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 determinations to discontinue the Company s real estate activities effective January 1, 2005, and approximated the total amount received from the disposition of its real estate interests related to HRP.

The closing price per share of the Common Stock on the American Stock Exchange on March 23, 2007 was $103.00.

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Item 6. ***Selected Financial Data***

The following table sets forth, as of the dates and for the periods indicated, selected financial information. The financial information is derived from our audited consolidated financial statements for such periods. The information should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and notes thereto contained in this document. The following information is not necessarily indicative of future results.

	Years Ended December 31,				
	2006	2005	2004	2003	2002
	(In thousands, except per share data)				
Revenues	$ 112,154	$ 134,607	$ 137,280	$ 104,720	$ 84,770
Expenses	111,382	134,554	125,609	100,145	84,702
Operating income	772	53	11,671	4,575	68
Other income (loss):					
Equity income (loss) from investments in energy affiliates	(10,418)	(8,500)	(9,901)	50	(187)
Interest expense	(616)	(545)	(1,197)	(1,636)	(1,392)
Other, net	566	1,532	2,918	2,390	2,940
Gain (loss) from disposition of HE III and HEC(a)	(17)	52,312	62,288		
	(10,485)	44,799	54,108	804	1,361
Income (loss) from continuing operations before income taxes	(9,713)	44,852	65,779	5,379	1,429
Income tax expense (benefit)	(2,988)	18,510	11,079	1,725	1,435
Income (loss) from continuing operations	(6,725)	26,342	54,700	3,654	(6)
Income (loss) from discontinued operations, net of tax:					
Income from real estate operations(b)			39,002	4,339	3,720
Income (loss) from hotel operations(c)			783	(568)	3,080
			39,785	3,771	6,800
Income (loss) before cumulative effect of change in accounting principles	(6,725)	26,342	94,485	7,425	6,794
Income from cumulative effect of change in accounting principles(d)					568
Net Income (Loss)	$ (6,725)	$ 26,342	$ 94,485	$ 7,425	$ 7,362

Income (Loss) from Continuing Operations Per Common Share

Basic	$ (4.44)	$ 18.22	$ 41.24	$ 2.68	$ (0.04)
Assuming dilution	(4.44)	17.47	36.79	2.59	(0.02)
Net Income (Loss) Per Common Share					
Basic	$ (4.44)	$ 18.22	$ 71.24	$ 5.47	$ 5.37
Assuming dilution	(4.44)	17.47	63.55	5.30	5.19
Dividends Per Common Share		$ 43.87			
Weighted Average Shares Outstanding					
Basic	1,514	1,446	1,326	1,347	1,361
Assuming dilution	1,514	1,508	1,487	1,390	1,415
Financial Condition					
Total assets	$ 107,597	$ 108,801	$ 157,317	$ 83,554	$ 69,548
Loans payable and capital lease obligations	10,892	6,812	9,136	23,938	17,130
Redeemable preferred stock	1,000	1,000	1,000	1,000	1,000
10% Debentures				6,569	6,625
Common stockholders equity	81,966	88,443	124,541	29,829	23,136

(a) In July 2005, the Company sold its investment in HE III. In December 2004, the Company sold its investment in Hallwood Energy Corporation (HEC).

(b) In July 2004, the Company sold its investments in HRP.

(c) The Company had 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) 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.

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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, two of its energy affiliates, in December 2004 and July 2005, respectively. The Company received total cash proceeds from these transactions of approximately $178,000,000. These proceeds were used to repay bank debt, the Company s 10% Debentures and other obligations and make additional investments in its energy affiliates. In addition, the Company paid cash dividends to its common stockholders of approximately $56,789,000, or $37.70 per share, on May 27, 2005, and approximately $9,324,000, or $6.17 per share, on August 18, 2005. The Company had approximately $10,054,000 in cash and cash equivalents at December 31, 2006.

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.

Textile Products. The Company derives substantially all of its operating revenues from the textile products activities of 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, Brookwood s 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, 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. In recent years, orders from the military for goods generally were significantly affected by the increased activity of the U.S. military. If this activity does not continue or declines, then orders from the military generally, including orders for Brookwood s products, may be similarly affected. Military sales of $53,885,000, $72,456,000 and $75,899,000 for 2006, 2005 and 2004, respectively, were 25.6% lower in 2006 and 4.5% lower in 2005 from the prior years.

The military has recently limited orders for existing products and adopted 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 a continuing challenge to adjust to changing specifications and production requirements. Brookwood is currently conducting research and development on various processes and products intended to comply with the revised specifications and participating in the bidding process for new military products. The U.S. government has recently released orders for goods that include Brookwood s products. However, to the extent Brookwood s products are not included in future purchases by the U.S. government for any reason, Brookwood s sales could be adversely affected. 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 higher domestic energy costs, are causing overall cost increases, which, together with product mix, have negatively impacted Brookwood s margins, a trend that appears likely to continue.

Brookwood continues to identify new market niches 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.

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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 NAFTA, the 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. Following the sale of HE III in July 2005, the Company s remaining affiliates were HE II, HE 4 and Hallwood Exploration. At that time, the Company owned between 20% and 26% of the entities (between 17% and 21% on a fully diluted basis) and accounted for the investments using the equity method of accounting, recording its pro rata share of net income (loss), partners capital transactions and comprehensive income (loss). These private companies were principally involved in acquiring oil and gas leases and drilling, gathering and sale of natural gas in the Barnett Shale formation of Parker, Hood and Tarrant Counties in North Texas, the Barnett Shale and Woodford Shale formations in West Texas, the Fayetteville Shale formation in 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.

Effective December 31, 2005, the remaining private energy affiliates were consolidated into HE4, which was renamed Hallwood Energy. All energy activities are now conducted by Hallwood Energy. The Company owns approximately 25% (20% after consideration of profits interests) of Hallwood Energy at December 31, 2006.

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, 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 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.

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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 2006 and 2005 were less than one percent of sales. The bill and hold inventory held for customers at December 31, 2006 and 2005, were approximately $73,000 and $107,000, respectively.

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.

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 and the level of expected operating expenses.

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Impairment of Investments Accounted for Under Equity Method. Investments that are accounted for under the equity method of accounting are reviewed for impairment when the fair value of the investment is believed to have fallen below the Company s carrying value. When such a decline is deemed other than temporary, an impairment charge is recorded to the statement of operations for the difference between the investment s carrying value and its estimated fair value at the time. In making the determination as to whether a decline is other than temporary, the Company considers such factors as the duration and extent of the decline, the investee s financial performance, and the Company s ability and intention to retain its investment for a period that will be sufficient to allow for any anticipated recovery in the investment s market value. However, a decline in the quoted market price below the carrying amount or the existence of operating losses is not necessarily indicative of a loss in value that is other than temporary. All are factors to be evaluated. Differing assumptions could affect whether an investment is impaired. From time to time, the Company performs impairment reviews and determines if a writedown is required.

The Company s evaluation of its investment in Hallwood Energy contains assumptions including (i) an evaluation of reserves using assumptions commonly used in the industry, some of which are not the same as are required by the SEC to be used for financial reporting purposes; (ii) realization of fair value for various reserve categories based upon Hallwood Energy s historical experience; and (iii) value per acre in a potential sale transaction, based upon acreage owned in productive areas with shale characteristics similar to acreage previously sold by HEC and HE III and other recent sale activity of acreage with shale formations.

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 past and 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 a net loss of $6,725,000 for the year ended December 31, 2006, compared to net income of $26,342,000 for 2005, and $94,485,000 for 2004. The Company reported a loss from continuing operations of $6,725,000 for 2006, compared to income of $26,342,000 for 2005 and $54,700,000 for 2004. Revenue from continuing operations was $112,154,000 for 2006, $134,607,000 for 2005 and $137,280,000 for 2004. Income from discontinued operations was $39,785,000 for 2004.

Revenues

Textile products sales of $112,154,000 in 2006 decreased by $20,954,000, or 15.7%, compared to $133,108,000 in 2005, which was a decrease of $3,168,000, or 2.3%, compared to $136,276,000 in 2004. The decreases were principally due to a decline of $18,571,000 in 2006 and $3,443,000 in 2005 in sales of specialty fabric to U.S. military contractors as a result of decreased orders from the military to Brookwood s customers, because of a limitation by the military for orders of existing products and the adoption of revised specifications for new products to replace the products for which Brookwood s customers have been suppliers. The decline in military sales was partially offset by Brookwood s development and marketing of new products and continued upgrade of its production equipment.

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Sales to one Brookwood customer, Tennier, accounted for more than 10% of Brookwood s net sales in each of the three years ended December 31, 2006. Its relationship with Tennier is ongoing. Sales to Tennier, which are included in military sales, were $31,300,000, $56,883,000 and $53,149,000 in 2006, 2005 and 2004, respectively, which represented 27.9%, 42.7% and 39.0% of Brookwood s sales. Sales to another customer, ORC, have increased in 2006 and accounted for more than 10% of Brookwood s sales. Its relationship with ORC is ongoing. Sales to ORC, which are also included in military sales, were $12,609,000, $10,099,000 and $13,229,000 in 2006, 2005 and 2004, respectively, which represented 11.2%, 7.6% and 9.7% of Brookwood s sales.

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 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 and $1,004,000 in 2004.

Expenses

Textile products cost of sales decreased by $12,165,000 to $93,134,000, or 11.6%, in 2006. The 2005 cost of sales of $105,299,000 increased by $2,527,000, or 2.5%, compared to $102,772,000 in 2004. The 2006 decrease principally resulted from reduced sales and changes in product mix, partially offset by increases in energy costs of $1,247,000, payroll costs of $446,000 and rent expense of $324,000. 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 goods and materials to Brookwood s facilities, including inbound freight, purchasing and receiving costs, inspection costs, internal transfer costs and other costs of the distribution network. Brookwood believes that the reporting and composition of cost of sales and gross margin is comparable with similar companies in the textile converting and finishing industry.

The gross profit margin was 17.0%, 20.9% and 24.6% in 2006, 2005 and 2004, respectively. The reduced gross profit margin for 2006 principally resulted from changes in product mix and higher energy costs. The reduced gross profit margin for 2005 principally resulted from changes in product mix, higher outside processing costs for laminated products and higher energy costs.

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

	Years Ended December 31,		
	2006	**2005**	**2004**
Textile products	$ 13,431	$ 16,132	$ 15,043
Corporate	4,817	11,624	6,792
Energy		1,499	1,002
Total	$ 18,248	$ 29,255	$ 22,837

Textile products administrative and selling expenses of $13,431,000 for 2006 decreased by $2,701,000, or 16.7%, from the 2005 amount of $16,132,000, which increased by $1,089,000, or 7.2%, compared to the 2004 amount of $15,043,000. The 2006 decrease was principally attributable to reduced royalties of $1,932,000, costs in 2005 associated with the dissolution of a former subsidiary in the amount of $471,000 and reduced salaries of $317,000, partially offset by plant relocation costs of $530,000 in 2006. 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 textile products administrative and selling expenses included items such as payroll, professional fees, sales commissions, marketing, rent, insurance, travel and royalties. Brookwood conducts research and development activities related to the exploration, development and production of innovative products and technologies. Research and development expenses were approximately $594,000 in 2006 and $335,000 in 2005 and were not significant in 2004.

Corporate administrative expenses were $4,817,000 for 2006, compared to $11,624,000 for 2005 and $6,792,000 for 2004. The 2006 decrease of $6,807,000 was principally attributable to bonus awards in 2005 of $5,000,000 to Mr. Gumbiner and $1,341,000 to those officers of the Company, other than Mr. Gumbiner, who held options to purchase common stock of the Company, in lieu of amounts such optionholders would have received had they exercised their options prior to the record date of the May 2005 and August 2005 cash distributions. Professional fees decreased by $188,000 for 2006, compared to 2005. The 2005 increase of $4,832,000 was primarily attributable to the aforementioned bonus awards to Mr. Gumbiner and other officers of the Company 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.

Administrative costs attributable to HPL, which commenced operations in October 2004, were $1,499,000 for the period from January 2005 to the May 2005 date of transfer and $1,002,000 from October 2004 to December 2004.

Other Income (Loss)

Equity income (loss) from investments in its energy affiliates, relating to the Company s proportionate share of income (loss) in Hallwood Energy and its predecessor affiliates, was comprised of the following (in thousands):

	Years Ended December 31,		
	2006	**2005**	**2004**
Hallwood Energy	$ (10,418)	$ 128	$ (234)
HE III		(8,628)	(223)
HEC			(9,444)
Total	$ (10,418)	$ (8,500)	$ (9,901)

The 2006 results for Hallwood Energy include production from two wells in the Fort Worth Basin that were sold to Chesapeake. All three of the remaining areas, Central Eastern Arkansas, West Texas, and South Louisiana were active in the drilling and/or completion phase of exploitation as of December 31, 2006.

In December 2006, Hallwood Energy recorded an impairment of $28,408,000 associated with its oil and gas properties and accrued $1,683,000 as a portion of a make-whole fee in connection with a subsequent prepayment of a loan. The make-whole fee was included in interest expense. The Company recorded its proportionate share of such impairment and interest expense in the approximate amount of $7,560,000.

The 2005 and 2004 amounts for Hallwood Energy represent the aggregate results of HE II, HE 4 and Hallwood Exploration for comparability purposes. In connection with the July 2005 disposition of HE III, HE II sold all of its 856 net acre lease holdings in Johnson County, Texas to Chesapeake for $3,000,000. The Company included its pro rata share of the gain from this transaction in 2005.

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 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.

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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):

	Years Ended December 31,		
	2006	2005	2004
Textile products	$ 601	$ 545	$ 398
Corporate	15		799
Total	$ 616	$ 545	$ 1,197

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 2006 of $15,000 was attributable to interest costs associated with the completion of an Internal Revenue Service examination of the Company s 2004 and 2005 federal income tax returns (discussed below). Corporate interest expense in 2004 principally related to the Company s Amended and Restated Credit Agreement and the 10% Debentures. All corporate level debt was repaid during 2004. The Amended and Restated Credit Agreement was repaid in July 2004 and the 10% Debentures were redeemed in September 2004.

Interest and other income was $566,000 in 2006, compared to $1,532,000 in 2005 and $1,536,000 in 2004. The 2006 decrease was principally due to reduced interest income earned on lower balances of cash and cash equivalents and lower income from investments in marketable securities which were sold or matured in 2005. The 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 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. In addition, the Company also recorded a receivable in 2005 of $469,000 for the settlement of a working capital adjustment with HPL. The receivable, which was reduced to $452,000 by certain post-closing adjustments, was contributed to Hallwood Energy in November 2006 as an additional capital investment. The Company recorded a $17,000 loss from the disposition of HE III in November 2006 in connection with the reduction of the receivable.

On December 15, 2004, HEC completed a merger with Chesapeake 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 2005.

Amortization of deferred revenue in the amount of $1,007,000 in 2004 was attributable to the noncompetition agreement associated with the sale of the Company s investment in a former energy affiliate based in Denver, Colorado, also known as Hallwood Energy Corporation. 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.

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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.