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HALLWOOD GROUP INC
Form 10-Q
August 14, 2002

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

MARK ONE

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

FOR THE TRANSITION PERIOD FROM _____ TO _____

FOR THE PERIOD ENDED JUNE 30, 2002

COMMISSION FILE NUMBER: 1-8303

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

DELAWARE
(State or other jurisdiction of
incorporation or organization)

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

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

75219
(Zip Code)

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

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

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

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

TITLE OF CLASS
Series B Redeemable Preferred Stock

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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 X NO ___

1,361,343 shares of Common Stock, \$.10 par value per share, were outstanding at July 31, 2002.

=====

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS (DOLLARS IN THOUSANDS)

ASSETS

	JUNE 30, 2002	DECEMBER 31, 2001
	-----	-----
	(UNAUDITED)	
REAL ESTATE		
Investments in HRP	\$13,409	\$12,261
Receivables and other assets		
Related parties	166	242
Other	57	55
	-----	-----
	13,632	12,558
TEXTILE PRODUCTS		
Inventories	18,214	16,753
Receivables		
Trade and other	12,209	11,896
Related party	2,107	5,217
Property, plant and equipment, net	9,167	9,426
Investment in joint venture	1,400	676
Prepays, deposits and other assets	621	1,030
	-----	-----
	43,718	44,998
OTHER		
Deferred tax asset, net	4,591	5,677
Cash and cash equivalents	2,463	3,006
Investment in HEC	1,423	--
Restricted cash	974	966
Hotel held for use - assets	490	448
Prepays, deposits and other assets	447	408
	-----	-----
	10,388	10,505
DISCONTINUED OPERATIONS		
Hotels held for sale		
Properties, net	--	6,602
Receivables and other assets	--	1,104
Deferred tax asset	--	1,800
	-----	-----
	--	9,506
	-----	-----
TOTAL	\$67,738	\$77,567
	=====	=====

See accompanying notes to consolidated financial statements.

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CONSOLIDATED BALANCE SHEETS (DOLLARS IN THOUSANDS)

LIABILITIES AND STOCKHOLDERS' EQUITY

	JUNE 30, 2002 ----- (UNAUDITED)
REAL ESTATE	
Accounts payable and accrued expenses	\$ 658
TEXTILE PRODUCTS	
Loans payable	14,884
Accounts payable and accrued expenses	8,149
	----- 23,033
OTHER	
10% Collateralized Subordinated Debentures	6,652
Deferred revenue - noncompetition agreement	4,632
Interest and other accrued expenses	3,938
Term loan	2,780
Capital lease obligations	1,304
Hotel held for use - liabilities	640
Convertible loan from stockholder	--
	----- 19,946
DISCONTINUED OPERATIONS	
Hotels held for sale	
Accounts payable and accrued expenses	537
Loans payable	--
	----- 537

TOTAL LIABILITIES	44,174
REDEEMABLE PREFERRED STOCK	
Series B, 250,000 shares issued and outstanding	1,000
STOCKHOLDERS' EQUITY	
Preferred stock, 250,000 shares issued and outstanding as Series B	--
Common stock, issued 2,396,103 shares at both dates;	
outstanding 1,361,343 shares at both dates	240
Additional paid-in capital	54,452
Accumulated deficit	(17,019)
Accumulated other comprehensive income	221
Treasury stock, 1,034,760 shares at both dates; at cost	(15,330)

TOTAL STOCKHOLDERS' EQUITY	22,564

TOTAL	\$ 67,738 =====

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See accompanying notes to consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

	SIX MONTHS ENDED JUNE 30,	
	2002	2001
REAL ESTATE		
Fees		
Related parties	\$ 2,378	\$ 3,000
Other	50	1,000
Equity income from investments in HRP	947	1,000
	3,375	5,000
Administrative expenses	513	1,000
Amortization	336	1,000
Litigation expense	--	2,000
	849	3,000
Income from real estate operations	2,526	1,000
TEXTILE PRODUCTS		
Sales		
Trade	34,771	35,000
Related party	8,981	1,000
Equity income from joint venture	723	1,000
	44,475	35,000
Cost of sales	37,204	29,000
Administrative and selling expenses	5,614	5,000
Interest	374	1,000
	43,192	35,000
Income from textile products operations	1,283	1,000
OTHER		
Amortization of deferred revenue - noncompetition agreement ...	1,208	1,000
Hotel revenue	898	1,000
Interest and other income	308	1,000
Equity loss from investment in HEC	(77)	1,000
	2,337	1,000

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Administrative expenses	974	
Hotel expenses	930	
Interest expense	430	1,
	-----	-----
	2,334	3,
	-----	-----
Other income (loss), net	3	(1,
	-----	-----
Income (loss) from continuing operations before income taxes	3,812	(
Income taxes	(1,354)	(
	-----	-----
Income (loss) from continuing operations	2,458	(1,

See accompanying notes to consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

		S

		20

Income from discontinued operations, net of tax		
Income from discontinued operations - Hotels		\$ 3
Income from discontinued operations - Energy		

Income from discontinued operations		3

Income before extraordinary loss and cumulative effect of changes in accounting principles		6
Extraordinary loss from early extinguishment of debt		

Income before cumulative effect of changes in accounting principles		6
Income (loss) from cumulative effect of changes in accounting principles		
Income from cumulative effect of SFAS No. 142 adoption		
Loss from cumulative effect of SFAS No. 133 adoption		

Income (loss) from cumulative effect of changes in accounting principles		-----
NET INCOME		6
Preferred stock dividend		-----

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NET INCOME AVAILABLE TO COMMON STOCKHOLDERS	\$ 6
	=====
PER COMMON SHARE	
BASIC	
Income (loss) from continuing operations after preferred dividend	\$
Income from discontinued operations	
Extraordinary loss from early extinguishment of debt	
Income (loss) from cumulative effect of changes in accounting principles	

Net income available to common stockholders	\$
	=====
ASSUMING DILUTION	
Income (loss) from continuing operations after preferred dividend	\$
Income from discontinued operations	
Extraordinary loss from early extinguishment of debt	
Income (loss) from cumulative effect of changes in accounting principles	

Net income available to common stockholders	\$
	=====
WEIGHTED AVERAGE SHARES OUTSTANDING	
Basic	1
	=====
Assuming Dilution	1
	=====

See accompanying notes to consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

	THREE MONTHS ENDED JUNE 30,	
	2002	2001
	-----	-----
REAL ESTATE		
Fees		
Related parties	\$ 1,266	\$ 1,266
Other	43	43
Equity income from investments in HRP	414	414
	-----	-----
	1,723	2,000
Administrative expenses	293	293

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Amortization	168	
Litigation expense	--	2,
	-----	-----
	461	2,
	-----	-----
Income (loss) from real estate operations	1,262	(
TEXTILE PRODUCTS		
Sales		
Trade	18,415	17,
Related party	4,516	
Equity income from joint venture	149	
	-----	-----
	23,080	18,
Cost of sales	19,151	14,
Administrative and selling expenses	2,945	2,
Interest	208	
	-----	-----
	22,304	17,
Income from textile products operations	776	
OTHER		
Amortization of deferred revenue - noncompetition agreement	604	
Hotel revenue	458	
Interest and other income	4	
Equity loss from investment in HEC	(36)	
	-----	-----
	1,030	
Administrative expenses	592	
Hotel expenses	493	
Interest expense	225	
	-----	-----
	1,310	1,
	-----	-----
Other income (loss), net	(280)	(
	-----	-----
Income (loss) from continuing operations before income taxes..	1,758	(1,
Income taxes	(616)	(
	-----	-----
Income (loss) from continuing operations	1,142	(1,

See accompanying notes to consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

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	THREE MONTHS JUNE 30
	----- 2002 -----
Income from discontinued operations, net of tax	
Income (loss) from discontinued operations - Hotels	\$ 2,258
Income from discontinued operations - Energy	--

Income from discontinued operations	2,258

Income before extraordinary loss	3,400
Extraordinary loss from early extinguishment of debt	--

NET INCOME	3,400

Preferred stock dividend	50

NET INCOME AVAILABLE TO COMMON STOCKHOLDERS	\$ 3,350
	=====
PER COMMON SHARE	
BASIC	
Income (loss) from continuing operations after preferred dividend ...	\$ 0.80
Income from discontinued operations	1.66
Extraordinary loss from early extinguishment of debt	--

Net income available to common stockholders	\$ 2.46
	=====
ASSUMING DILUTION	
Income (loss) from continuing operations after preferred dividend ...	\$ 0.80
Income from discontinued operations	1.66
Extraordinary loss from early extinguishment of debt	--

Net income available to common stockholders	\$ 2.46
	=====
WEIGHTED AVERAGE SHARES OUTSTANDING	
Basic	1,361
	=====
Assuming Dilution	1,361
	=====

See accompanying notes to consolidated financial statements.

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(IN THOUSANDS)
(UNAUDITED)

	THREE MONTHS ENDED JUNE 30,	
	2002	2001
	-----	-----
NET INCOME	\$ 3,400	\$ 3,588
Other Comprehensive Income (Loss)		
Pro rata share of other comprehensive income from equity investments:		
Adoption of SFAS No. 133		
Cumulative effect	--	--
Change in fair value of derivatives	--	--
Realized upon disposition of energy investment ...	--	3,009
Amortization of interest rate swap	(15)	--
	-----	-----
Other comprehensive income (loss)	(15)	3,009
	-----	-----
COMPREHENSIVE INCOME	\$ 3,385	\$ 6,597
	=====	=====

See accompanying notes to consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

	COMMON STOCK		ADDITIONAL	ACCUMULATED	ACCUMULATED	OTHER
	SHARES	PAR VALUE	PAID-IN	DEFICIT	DEFICIT	COMPREHENSIVE
	-----	-----	-----	-----	-----	-----
BALANCE, JANUARY 1, 2002	2,396	\$ 240	\$ 54,452	\$ (23,729)	\$	250
Net income				6,760		
Preferred stock dividend ..				(50)		
Pro rata share of stockholders' equity transactions from equity investment:						
Amortization of interest rate swap						(29)

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BALANCE, JUNE 30, 2002	2,396	\$ 240	\$ 54,452	\$(17,019)	\$ 221
	=====	=====	=====	=====	=====

See accompanying notes to consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

	SIX MONTHS EN JUNE 30	
	2002	
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 6,760	\$
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of deferred revenue - noncompetition agreement	(1,208)	
Equity income from textile products joint venture	(723)	
(Income) loss from cumulative effect of changes in accounting principles	(568)	
(Increase) decrease in deferred tax asset	1,086	
Equity income from investments in HRP	(947)	
Depreciation and amortization	1,026	
Equity loss from investment in HEC	77	
Amortization of deferred gain from debenture exchange	(25)	
Litigation expense	--	
Extraordinary loss from early extinguishment of debt	--	
Net change in textile products assets and liabilities	503	
Net change in other assets and liabilities	(470)	
Discontinued operations:		
Extraordinary gain from extinguishment of hotel debt	(5,789)	
Net change in other hotel assets and liabilities	242	
(Increase) decrease in deferred tax asset	1,800	
Gain from disposition of Hallwood Energy	--	
Equity income from investments in Hallwood Energy	--	
Net cash provided by operating activities	1,764	
CASH FLOWS FROM INVESTING ACTIVITIES		
Investment in HEC common stock	(1,500)	
Investments in textile products property and equipment	(369)	
Investment in hotel held for use	(17)	
Discontinued operations:		
Proceeds from sale of Hallwood Energy	--	
Proceeds from noncompetition agreement	--	
Net cash provided by (used in) investing activities	(1,886)	
CASH FLOWS FROM FINANCING ACTIVITIES		

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Proceeds from bank borrowings and loans payable	3,429
Repayment of bank borrowings and loans payable	(3,714)
Payment of deferred loan costs	(86)
Payment of preferred stock dividend	(50)
Discontinued operations:	
Repayment of hotel bank borrowings and loans payable	--

Net cash (used in) financing activities	(421)

NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(543)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	3,006

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

See accompanying notes to consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2002

(UNAUDITED)

NOTE 1 -- INTERIM CONSOLIDATED FINANCIAL STATEMENTS AND ACCOUNTING POLICIES

Interim Consolidated Financial Statements. The unaudited consolidated financial statements of The Hallwood Group Incorporated (the "Company") have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and disclosures required by accounting principles generally accepted in the United States of America, although, in the opinion of management, all adjustments considered necessary for a fair presentation have been included. These 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, 2001.

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

The textile products operations are conducted through the Company's wholly owned Brookwood Companies Incorporated ("Brookwood") subsidiary. Brookwood is a complete textile service firm that develops and produces innovative fabrics and related products through specialized finishing, treating and coating processes. In 2000, Brookwood formed a joint venture with an unrelated third party that is also in a textile related industry. The joint venture has been developing advanced lightweight, water resistant fabrics which have been well received by customers. Continued development of these fabrics for military, industrial and consumer applications is a key element of Brookwood's business plan.

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Discontinued Operations. In December 2000, the Company decided to discontinue and dispose of its hotel segment, which at that time consisted of five properties; accordingly, hotel operations were reclassified as a discontinued operation. Two hotels were disposed of in 2001, one hotel was sold in January 2002 and the lender completed a foreclosure on one hotel in June 2002. The Company determined in late 2001 that it would retain and continue to operate a leasehold interest in one hotel. Balance sheet presentation for the two hotels which have been disposed of in 2002 are reported as "Hotels held for sale" and the retained leasehold interest as "Hotel held for use."

In March 2001, the Company announced the sale of its energy segment; accordingly, energy operations were reclassified as a discontinued operation. Prior to the disposition, the Company's energy revenues consisted of its pro rata share of earnings of Hallwood Energy Corporation ("Hallwood Energy"), a publicly traded oil and gas company, accounted for on the equity method of accounting.

New Accounting Pronouncements. Statement of Financial Accounting Standards No. 141 - Business Combinations ("SFAS No. 141") became effective July 1, 2001 and prohibits pooling-of-interests accounting for acquisitions. Statement of Financial Accounting Standards No. 142 - Goodwill and Other Intangible Assets ("SFAS No. 142") became effective January 1, 2002 and specifies that goodwill and some intangible assets will no longer be amortized but instead will be subject to periodic impairment testing. The effect of adopting SFAS No. 142 had an impact on the Company's financial statements to the extent that the unamortized amount of negative goodwill associated with the Company's equity investment in HRP was accounted for as a cumulative effect adjustment.

Statement of Financial Accounting Standards No. 143 - Accounting for Asset Retirement Obligations ("SFAS No. 143") was issued in June 2001, and will be adopted by the Company on January 1, 2003. This Statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The Company has not yet determined the effect adopting SFAS No. 143 will have on its financial statements.

Statement of Financial Accounting Standards No. 144 - Accounting for the Impairment or Disposal of Long-lived Assets ("SFAS No. 144") was issued in August 2001, and was adopted by the Company on January 1, 2002. This Statement supersedes SFAS No. 121, "Accounting for the Impairment of Long-lived Assets and for Long-lived Assets to Be Disposed Of ", and the accounting and reporting provisions of APB Opinion No. 30, "Reporting the

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2002
(UNAUDITED)

Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions", for the disposal of a segment of a business (as previously defined in that Opinion). This statement retains the requirements of SFAS No. 121 to (a) recognize an impairment loss, only if the carrying amount of a long-lived asset is not recoverable from its undiscounted cash flows and (b) measure an impairment loss as the difference between the carrying amount and fair value of the asset. This statement requires that a long-lived asset to be

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abandoned, exchanged for a similar productive asset, or distributed to owners in a spinoff be considered held and used until it is disposed of. The accounting model for long-lived assets to be disposed of by sale is used for all long-lived assets, whether previously held and used or newly acquired. The accounting model retains the requirement of SFAS No. 121 to measure a long-lived asset classified as held for sale at the lower of its carrying amount or fair value less cost to sell and to cease depreciation. This statement requires that the current and historical results of disposed properties and assets held for sale be classified as discontinued operations. The Company early adopted the requirements of this statement and accordingly, hotel assets disposed of or to be disposed of have been reclassified as discontinued operations for each of the periods presented.

Statement of Financial Accounting Standards No. 145 - Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections ("SFAS No. 145") was issued in May 2002 and is effective for fiscal years beginning and transactions occurring after May 15, 2002. This statement rescinds certain authoritative pronouncements and amends, clarifies or describes the applicability of others. The Company has not yet determined the effect adopting SFAS No. 145 will have on its financial statements.

Statement of Financial Accounting Standards No. 146 - Accounting for Costs Associated with Exit or Disposal Activities ("SFAS No. 146") was issued in June 2002, and will be adopted by the Company on January 1, 2003. This statement addresses financial accounting and reporting of costs associated with exit or disposal activities. The Company has not yet determined the effect adopting SFAS No. 146 will have on its financial statements.

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

NOTE 2 -- INVESTMENTS IN REAL ESTATE AFFILIATE (DOLLAR AMOUNTS IN THOUSANDS)

DESCRIPTION OF INVESTMENT	AS OF JUNE 30, 2002		AMOUNT AT WHICH CARRIED AT	
	NUMBER OF UNITS	COST OR ASCRIBED VALUE	JUNE 30, 2002	DECEMBER 31, 2001
HALLWOOD REALTY PARTNERS, L.P.				
- General partner interest	--	\$ 8,650	\$ 1,606	\$ 1,943
- Limited partner interest	330,432	8,799	11,803	10,318
		-----	-----	-----
Totals		\$ 17,449	\$ 13,409	\$ 12,261
		=====	=====	=====

At June 30, 2002, Hallwood Realty, LLC ("Hallwood Realty") and HWG, LLC, wholly owned subsidiaries of the Company, owned a 1% general partner interest and a 21% limited partner interest in its HRP affiliate, respectively. The Company accounts for its investment in HRP using the equity method of accounting. Prior to January 1, 2002, the Company recorded amortization of the amount that the Company's share of the underlying equity in net assets of HRP exceeded its investment on the straight line basis over nineteen years, which was \$568,000 as of January 1, 2002. In accordance with SFAS No. 142, the unamortized amount of such "negative goodwill" has been recorded as income from cumulative effect of a change in accounting principle. The Company also records non-cash adjustments for the elimination of intercompany profits with a corresponding adjustment to equity income, its pro-rata share of HRP's partner

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capital transactions with corresponding adjustments to additional paid-in capital and its pro-rata share of HRP's comprehensive income. The cumulative amount of such non-cash adjustments, from the original date of investment through June 30, 2002, resulted in a \$1,699,000 decrease in the carrying value of the HRP investment. In 2001, the Company also recognized an extraordinary loss of \$9,000 from the recognition of the Company's pro rata share of HRP's extraordinary loss from early extinguishment of debt and a \$40,000 loss from the Company's pro rata share of HRP's loss from cumulative effect of SFAS No. 133 adoption.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS JUNE 30, 2002 (UNAUDITED)

The carrying value of the Company's general partner interest of HRP includes the value of intangible rights to provide asset management and property management services. The Company amortizes that portion of the general partner interest ascribed to the management rights. For the six months ended June 30, 2002 and 2001 such amortization was \$336,000 in each period.

As further discussed in Note 11, the Delaware Court of Chancery in July 2001 rendered its opinion regarding certain litigation involving the Company. The court determined that the defendants, including the Company, should pay to HRP a judgment of \$3,417,000 plus pre-judgment interest of approximately \$2,891,000 from August 1995. The judgment amount, which represented the court's determination of an underpayment by the Company for certain limited partnership units purchased by the Company in 1995 from HRP, was considered additional purchase price and was added to the Company's investment in the limited partnership units. The interest component of the judgment was recorded as an expense, net of the Company's pro rata share of the income that will be reported by HRP. In October 2001, the Company paid \$6,405,000, including post-judgment interest, to HRP, subject to an arrangement that it be returned in full or part if the judgment is modified or reversed on appeal.

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

The quoted market price per unit and the Company's carrying value per limited partner unit (AMEX symbol HRY) at June 30, 2002 were \$68.75 and \$35.72, respectively. The general partner interest is not publicly traded.

NOTE 3 -- INVESTMENT IN HEC

In January 2002, the Company invested \$1,500,000 in a newly-formed private energy company - Hallwood Energy Corporation ("HEC"). HEC is presently in the developmental stage, having drilled four test wells, the results of which are being analyzed to determine if any of the wells may ultimately become economically feasible to place into commercial production and, if so, to determine the extent of future development. The Company owns approximately 24% of HEC and accounts for the investment using the equity method of accounting. It reported an equity loss, representing its pro rata share of HEC's net loss, of \$36,000 and \$77,000 in the three month and six month periods ended June 30, 2002, respectively.

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NOTE 4 -- LOANS PAYABLE

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

	JUNE 30, 2002 -----	DEC 2 -----
Textile Products		
Revolving credit facility, prime + 0.25% or Libor + 3.25%, due January 2004	\$12,649	\$1
Acquisition credit facility, prime + 1.00% or Libor + 3.25%, due January 2004	1,000	
Equipment term loan, 9.37% fixed, due October 2005	717	
Equipment term loan, Libor + 3.25%, due March 2007	518	
	-----	-----
	14,884	1
Other		
Term loan, 7% fixed, due April 2005	2,780	
Revolving credit facility, prime + 0.50% or Libor + 3.25%, due April 2005	--	
Capital lease obligations, 12.18% fixed, due December 2004	1,304	
Convertible loan from stockholder, 10% fixed, repaid March 2002	--	
	-----	-----
	4,084	-----
	-----	-----
Total	\$18,968 =====	\$1 =====

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2002

(UNAUDITED)

Further information regarding loans payable is provided below:

Textile Products

Revolving Credit Facility. In December 1999, the Company's Brookwood subsidiary entered into a revolving credit facility in an amount up to \$17,000,000 with Key Bank National Association ("Key Credit Agreement") to replace its former credit facility. Availability for direct borrowings and letter of credit obligations under the Key Credit Agreement are limited to the lesser of the facility amount or the borrowing base as defined. Borrowings are collateralized by accounts receivable, inventory imported under trade letters of credit, certain finished goods inventory, certain machinery and equipment and all of the issued and outstanding capital stock of Brookwood and its subsidiaries.

The Key Credit Agreement has been extended through January 2, 2004, bears interest at Brookwood's option of prime plus 0.25% (5.00% at June 30, 2002) or Libor plus 3.25%, contains covenants, including minimum net income levels by

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quarter, maintenance of certain financial ratios, restrictions on dividends and repayment of debt or cash transfers to the parent company.

Cash dividends and tax sharing payments to the parent company are contingent upon Brookwood's compliance with the covenants contained in the loan agreement. At June 30, 2002, Brookwood was in compliance with its loan covenants and had an additional \$773,000 of borrowing base availability under its revolving line of credit facility.

Acquisition Credit Facility. The Key Credit Agreement provides for a \$2,000,000 acquisition revolving credit line. This facility bears interest at Brookwood's option of prime plus 1.00% (5.75% at June 30, 2002) or Libor plus 3.25%. Brookwood has borrowed \$1,000,000 under this facility.

Equipment Credit Facility. The Key Credit Agreement provides for a \$2,000,000 equipment revolving credit line. The facility bears interest at Libor plus 2.75%. During 2000 Brookwood borrowed \$1,000,000 under this facility, and in September 2000 converted that amount into a term loan, at a fixed rate of 9.37%, with a maturity of October 2005 and a monthly principal and interest payment of \$20,938. During 2002 Brookwood borrowed an additional \$542,000 under this facility and in February 2002 converted that amount into a term loan, at a variable rate of Libor plus 3.25% (5.10% at June 30, 2002), with a maturity date of March 2007 and a monthly principal and interest payment of \$10,253. Brookwood has \$458,000 availability under this facility.

The outstanding balance of the combined Key Bank credit facilities at June 30, 2002 was \$14,884,000.

Other

Term Loan and Revolving Credit Facility. In March 2002, the Company and its HWG, LLC subsidiary entered into a \$7,000,000 credit agreement with First Bank & Trust, N.A. The facility is comprised of a \$3,000,000 term loan and a \$4,000,000 revolving credit facility (the "Term Loan and Revolving Credit Facility"). Term loan proceeds were used in part to repay the aforementioned \$1,500,000 convertible loan from stockholder in March 2002, bears interest at a fixed rate of 7%, matures April 1, 2005, and is fully amortizing requiring a monthly payment of \$92,631. The outstanding principal balance of the loan at June 30, 2002 was \$2,780,000.

The revolving credit facility bears interest at the Company's option of prime plus 0.50% or Libor plus 3.25%, and matures April 1, 2005. Collateral for the Term Loan and Revolving Credit Facility is 300,397 HRP limited partner units, and contains various financial and non-financial covenants, including the maintenance of financial ratios, restrictions on new indebtedness and the payment of dividends. The Company has not drawn any funds on the Revolving Credit Facility, and therefore has \$4,000,000 of unused borrowing capacity.

Capital Lease Obligations. During 1999, the Company's Brock Suite Hotels subsidiaries entered into three separate five-year capital lease agreements for furniture, fixtures and building improvements at a cost of \$2,085,000 for three GuestHouse Suites Plus properties. The Company has pledged 30,035 HRP limited partner units as additional collateral to secure the leases. The lease terms commenced January 2000 and expire in December 2004.

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The combined monthly lease payment is \$46,570 and the effective interest rate is 12.18%. Interest expense in the amount of \$112,000, representing the full interest costs through expiration of the capital leases associated with the two disposed hotels, has been accrued at June 30, 2002, as a reduction of gain from extinguishment of debt. The outstanding principal and interest balance at June 30, 2002 was \$1,304,000.

Convertible Loan from Stockholder. In order to provide sufficient funds to meet the Company's cash flow requirements and maintain compliance with the loan covenants contained in the former Senior Secured Term Loan, the Company entered into three loan agreements with an entity associated with its chairman and principal stockholder, Anthony J. Gumbiner. Two loans were repaid in December 2001 and the remaining loan was repaid in March 2002 in the amount of \$1,648,000, which represented principal of \$1,500,000 and accrued interest of \$148,000.

NOTE 5 -- DEBENTURES

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

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

DESCRIPTION -----	JUNE 30, 2002 -----	DECEMBER 31, 2001 -----
10% Debentures (face amount)	\$6,468	\$6,468
Unamortized gain, net of accumulated amortization	184	209
	-----	-----
Totals	\$6,652	\$6,677
	=====	=====

NOTE 6 -- DISCONTINUED OPERATIONS - HOTEL ASSETS HELD FOR SALE

In December 2000, the Company decided to discontinue and dispose of its hotel segment, principally by allowing its non-recourse debtholders to assume ownership of the properties through foreclosure or by selling or otherwise disposing of its hotel properties. The Company's hotel segment consisted of three owned properties and two leased properties.

The Company determined that it would retain its leasehold interest in the GuestHouse Suites hotel in Huntsville, Alabama. The Company continues to operate the hotel, subject to a lease concession from the owner. Accordingly, this hotel has been classified as hotel asset held for use, and prior year operating results have been reclassified to continuing operations in the other segment. The carrying value of the leasehold interest was \$286,000 and \$331,000, at June 30, 2002 and December 31, 2001, respectively.

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In January 2002, with assistance and consent of the mortgage lender, the Company sold the GuestHouse Suites hotel in Tulsa, Oklahoma for \$3,000,000. The Company received no cash proceeds from the sale. In connection with the sale, the parties entered into a loan modification and assumption agreement which, among other terms, included a release that discharged the Company from any further loan obligation. The Company recognized a gain from extinguishment of debt of \$2,552,000, before a deferred tax charge of \$875,000 in the 2002 first quarter, which has been classified within discontinued operations.

In February 2002, the mortgage lender for the GuestHouse Suites hotel in Greenville, South Carolina obtained a court judgement of foreclosure. In connection with the foreclosure, the lender waived its right to a deficiency judgement against the Company. The lender completed the foreclosure in June 2002 and the Company recognized a

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gain from extinguishment of debt in the amount of \$3,237,000, before a deferred tax charge of \$925,000 in the 2002 second quarter, which had been classified within discontinued operations.

A summary of the non-recourse loans payable associated with the hotels held for sale is detailed below (in thousands):

DESCRIPTION -----	JUNE 30, 2002 -----	DECEMBER 31, 2001 -----
Term loan, 7.86% fixed, extinguished May 2002	--	\$ 6,514
Term loan, 8.20% fixed, extinguished January 2002	--	5,095
Total	--	\$11,609 =====

The Company is a defendant in two lawsuits in connection with the disposition of hotel properties in 2001. Plaintiffs allege violations of franchise and lease agreements and seek damages of approximately \$1,500,000. The owner of the Longboat Key Holiday Inn hotel has made a claim against the Company under a guaranty which is in discovery, and the franchiser of the Embassy Suites hotel has made a claim for liquidated damages under a franchise contract which is in mediation. Management believes that the claims are without merit and intends to vigorously defend the cases.

A summary of discontinued hotels operations is detailed below (in thousands)

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	THREE MONTHS ENDED JUNE 30,	
	----- 2002 -----	2001 -----
Gain from extinguishment of debt	\$ 3,237	\$ --
Deferred federal income tax (expense)	(925)	--
Sales	67	2,320
	-----	-----
	2,379	2,320
Expenses		
Operating expenses	66	1,829
Interest expense	46	668
Other disposition costs	9	--
Loss reserve (recovery)	--	(166)
	-----	-----
	121	2,331
	-----	-----
Income (loss) from discontinued hotel operations	\$ 2,258	\$ (11)
	=====	=====

NOTE 7 -- DISCONTINUED OPERATIONS - ENERGY

In March 2001, the Company agreed to sell its investment in its Hallwood Energy affiliate, which represented the Company's energy operations, to Pure Resources II, Inc., an indirect wholly owned subsidiary of Pure Resources, Inc., subject to Hallwood Energy's shareholder approval which was obtained in May 2001. The all-cash transaction was structured as a first step tender offer followed by a cash merger to acquire all remaining shares of Hallwood Energy. The Company received \$18,000,000 for the tender of its 1,440,000 shares of common stock in May 2001 and received an additional amount of \$7,250,000, pursuant to the terms of a noncompetition agreement upon the completion of the merger in June 2001.

Under the noncompetition agreement, the Company agreed to refrain from taking certain actions without the prior written consent of Pure and Hallwood Energy. These covenants were made by the Company in consideration of the transactions contemplated by the merger agreement and the payment by Pure to the Company. For a period of three years after the effective date of the merger agreement, the Company will not, directly or indirectly, engage in oil and

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gas activities in certain geographic areas without the prior consent of Pure. The Company has also agreed to keep Hallwood Energy's confidential and proprietary information strictly confidential.

Accordingly, energy operations have been segregated from the Company's

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continuing operations and reported as discontinued operations. A summary of the income from discontinued energy operations is detailed below (in thousands):

	THREE MONTHS ENDED JUNE 30,		S
	2002	2001	
Gain from disposition of investment in HEC	--	\$ 8,725	--
Deferred income tax benefit (expense)	--	(2,914)	--
Current income tax (expense)	--	(500)	--
Equity income from investment in Hallwood Energy	--	495	--

Income from discontinued energy operations	--	\$ 5,806	--
		=====	

The Company began amortizing the deferred revenue from the noncompetition agreement in the amount of \$7,250,000, over a three-year period commencing June 2001. The amortization, which is reported in the "other" section of the statement of income, was \$1,208,000 and \$604,000 in the six months and three months ended June 30, 2002, compared to \$201,000 in the 2001 second quarter.

NOTE 8 -- INCOME TAXES

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

	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,	
	2002	2001	2002	2001
Continuing Operations				
Federal				
Deferred	\$ 520	\$ 334	\$ 1,086	\$ 534
Current	11	(33)	23	(12)
	-----	-----	-----	-----
Sub-total	531	301	1,109	522
State	85	82	245	133
	-----	-----	-----	-----
Total	\$ 616	\$ 383	\$ 1,354	\$ 655
	=====	=====	=====	=====
Discontinued Operations				
Federal				
Deferred	\$ 925	\$ 2,914	\$ 1,800	\$ (672)
Current	--	400	--	400
	-----	-----	-----	-----
Sub-total	925	3,314	1,800	(272)
State	--	100	--	100
	-----	-----	-----	-----

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Total	\$ 925	\$ 3,414	\$ 1,800	\$ (172)
	=====	=====	=====	=====

The amount of the deferred tax asset (net of valuation allowance) was \$4,591,000 at June 30, 2002 (all of which is attributable to continuing operations). The deferred tax asset arises principally from the anticipated utilization of the Company's NOLs and tax credits from the implementation of various tax planning strategies, which include the potential sale of certain real estate investments if necessary, to supplement income from operations to fully realize the net recorded tax benefits before their expiration.

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

NOTE 9 -- SUPPLEMENTAL DISCLOSURES TO THE CONSOLIDATED STATEMENTS OF CASH FLOWS

	SIX MONTHS ENDED JUNE 30,	
	2002	2001
	-----	-----
Supplemental schedule of non-cash investing and financing activities:		
Hotel assets and liabilities relinquished in connection with debt extinguishment		
Loan payable	\$ 11,609	--
Other liabilities, net	837	--
Hotel properties	(6,552)	--
Deferred tax asset	(1,800)	--

	\$ 4,094	--
	=====	
Pro rata share of stockholders' equity transactions of equity investment:		
Adoption of SFAS No. 133		
Cumulative effect	\$ --	\$ (4,311)
Realized upon disposition of energy investment	--	3,009
Change in fair value of derivatives	--	1,302
Amortization of interest rate swap	(29)	--
	-----	-----
Other comprehensive loss	\$ (29)	\$ --
	=====	=====

Supplemental disclosures of cash payments:

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Interest paid	\$ 988	\$ 1,877
Income taxes paid (refunded)	(184)	537

NOTE 10 -- COMPUTATION OF EARNINGS PER SHARE

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

	THREE MONTHS ENDED JUNE 30,	
	2002	2001
INCOME (LOSS) AVAILABLE TO COMMON STOCKHOLDERS		
Income (loss) from continuing operations	\$ 1,142	\$ (1,406)
Less dividend on preferred stock	(50)	(50)
Impact of assumed loan conversion	--	--
Income (loss) from continuing operations available to common stockholders - basic	\$ 1,092	\$ (1,456)
WEIGHTED AVERAGE SHARES OUTSTANDING		
Basic	1,361	1,425
Incremental shares from assumed loan conversions	--	--
Assuming dilution	1,361	1,425

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The options issued under the Company's stock option plan are antidilutive for all periods presented.

NOTE 11 -- LITIGATION, CONTINGENCIES AND COMMITMENTS

Reference is made to Note 18 to the consolidated financial statements contained in Form 10-K for the year ended December 31, 2001.

Beginning in 1997, the Company and its HRP affiliate have been defendants in two lawsuits that were brought by Gotham Partners, L.P. in the Delaware Court of Chancery. The first suit filed in February 1997, styled Gotham Partners, L.P. v. Hallwood Realty Partners, L.P. and Hallwood Realty Corporation (C.A. No. 15578), sought access to certain books and records of HRP and was

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subsequently settled, allowing certain access. The suit was dismissed in April 2001. The second action, filed in June 1997, styled Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., et al (C.A. No. 15754), against the Company, HRP, HRC and the directors of HRC, alleges claims of breach of fiduciary duties, breach of HRP's partnership agreement and fraud in connection with certain transactions involving HRP's limited partnership units in the mid 1990's. The Company is alleged to have aided and abetted the alleged breaches. In June 2000, after completing fact discovery, all parties moved for summary judgment on several issues. In September and October 2000, the Delaware court issued three separate written opinions resolving the summary judgment motions. In the opinions, the court ruled that trial would be required as to all issues, except that (i) Gotham was found to have standing to pursue its derivative claims; (ii) defendants were entitled to judgment dismissing the fraud claim; (iii) the general partner was entitled to judgment dismissing the breach of fiduciary duty claims brought against it; and (iv) the general partner's outside directors were entitled to judgment dismissing all claims brought against them. A five-day trial was held in January 2001. In July 2001, the Delaware Court of Chancery rendered its opinion. In its decision, the court determined that an option plan and a sale of units to the Company in connection with a reverse unit split implemented by HRP in 1995 were in compliance with HRP's partnership agreement. The court also found that the sale of units to the Company in connection with a 1995 odd-lot offer by HRP did not comply with certain procedures required by the HRP partnership agreement. The court ruled that the defendants other than HRP pay a judgment in the amount of \$3,417,000, plus pre-judgment interest of approximately \$2,891,000 from August 1995 to HRP. The judgment amount represents what the court determined was an underpayment by the Company. In August 2001, the plaintiff and certain defendants appealed the Court of Chancery's judgment to the Delaware Supreme Court. Those appeals are pending. Oral arguments were heard on February 12, 2002 and a rehearing en banc was held on March 26, 2002. In October 2001, the Company paid \$6,405,000, including post judgment interest, to HRP, subject to an arrangement that it be returned in full or part if the judgment is modified or reversed on appeal. If the appellate court reverses the judgment, any subsequent ruling by the trial court on remand may be more or less favorable to the Company.

In February 2000, HRP filed a lawsuit in the United States District Court for the Southern District of New York styled Hallwood Realty Partners, L.P. v. Gotham Partners, L.P., et al (Civ. No. 00 CV1115) alleging violations of the Securities Exchange Act of 1934 by certain purchasers of HRP's limited partnership units, including Gotham Partners, L.P., Gotham Partners, III L.P., Private Management Group, Inc., Interstate Properties, Steven Roth and EFO Realty, Inc., by virtue of those purchasers' misrepresentations and/or omissions in connection with filings required under the Securities Exchange Act of 1934. The complaint further alleged that the defendants, by acquiring more than 15% of the outstanding HRP limited partnership units, have triggered certain rights under its Unit Purchase Rights Agreement, for which HRP was seeking declaratory relief. HRP sought various forms of relief, including declaratory judgments, divestiture, corrective disclosures, a "cooling-off" period and damages, including costs and disbursements. Discovery was completed in December 2000 and trial was held in February 2001. In February 2001, the court rendered a decision in favor of the defendants and the court ordered the complaint dismissed. HRP filed a Notice of Appeal in March 2001 with respect to the February 2001 dismissal of the complaint and other matters. All parties filed briefs with the Second Circuit. Oral arguments were heard on March 4, 2002. On April 11, 2002, the U.S. Court of Appeals for the Second Circuit upheld the lower court's ruling in favor of the defendants. On April 25, 2002, HRP filed with the court a Petition for Rehearing en banc with respect to the April 11, 2002 decision. On June 3, 2002 the Second Circuit denied the petition.

In December 1999, the Company deposited \$900,000 into an escrow account to secure the maximum amount which could be payable by the Company in a lawsuit brought by a former promissory note holder. The trial was held

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in June 2001 in the Delaware Court of Chancery. The parties submitted post-trial briefings in September 2001. In February 2002, the court rendered its decision in favor of the Company. On March 22, 2002, the court entered an order that provides for the return of approximately \$974,000, including accrued interest, to the Company from the escrow account. The noteholder filed an appeal on April 19, 2002. The parties have filed their appeal and reply briefs and oral arguments before the Delaware Supreme Court have been scheduled for September 2002.

The Company is currently a defendant in two lawsuits in connection with the disposition of two hotel properties. Plaintiffs allege violations of franchise and lease agreements and seek damages of approximately \$1,500,000. The owner of the Longboat Key Holiday Inn hotel has made a claim against the Company under a guaranty which is in discovery, and the franchiser of the Embassy Suites hotel has made a claim for liquidated damages under a franchise contract which is in mediation. Management believes that the claims are without merit and intends to vigorously defend the cases.

In December 1999 the Company distributed certain assets, and incurred a contingent obligation, under the agreement to separate the interests of its former president and director (the "Separation Agreement"). Interest on the contingent obligation was imputed at 12.75% through December 31, 2001. In December 2001, the Company accrued an additional \$500,000 under this agreement, all of which is expected to be paid in 2002. The contingent obligation of \$3,250,000 at June 30, 2002, is the amount of all remaining payments under the Separation Agreement and is included in other accrued expenses.

In February 2000, the Company, through a wholly owned subsidiary, acquired the assets of a company in a textile products-related industry. The purchase price was \$1,450,000 in cash plus contingent payments of up to \$3,000,000 based on specified levels of earnings over the next four years. Effective December 31, 2001, in consideration of 36 monthly payments aggregating approximately \$375,000, the contingent obligation had been reduced to a percentage of cash flow from the acquired subsidiaries, as defined, for the remaining years under this agreement.

NOTE 12 -- SEGMENT AND RELATED INFORMATION

The following represents the Company's reportable segment operations for the six months ended June 30, 2002 and 2001, respectively (in thousands):

	REAL ESTATE	TEXTILE PRODUCTS	OTHER	DISCONTINUED OPERATIONS	CONS -IDA
	-----	-----	-----	-----	-----
SIX MONTHS ENDED JUNE 30, 2002					
Total revenue from external sources.....	\$ 3,375	\$ 44,475	\$ 2,337		\$ 5

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	=====	=====	=====	=====
Operating income.....	\$ 2,526	\$ 1,283		\$
	=====	=====		
Unallocable income, net.....			\$ 3	
			=====	-----
Income from continuing operations before income taxes.....				\$
				=====
Income from discontinued operations.....			\$ 3,734	\$
			=====	=====
SIX MONTHS ENDED JUNE 30, 2001				
Total revenue from external sources.....	\$ 5,076	\$ 35,812	\$ 1,166	\$ 4
	=====	=====	=====	=====
Operating income (loss).....	\$ 1,437	\$ 27		\$
	=====	=====		
Unallocable expenses, net.....			\$ (1,864)	(
			=====	-----
Income (loss) from continuing operations before income taxes.....				\$
				=====
Income from discontinued operations.....			\$ 10,744	\$ 1
			=====	=====

No differences have occurred in the basis or methodologies used in the preparation of this interim segment information from those used in the December 31, 2001 annual report. Total assets of the Company's operating segments have not materially changed since the December 31, 2001 annual report.

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NOTE 13 -- CUMULATIVE EFFECT OF CHANGES IN ACCOUNTING PRINCIPLES

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

During 2001, management had conducted an analysis of the carrying value of certain intangible assets related to the textile products segment and recorded an impairment charge of \$1,446,000 as of December 31, 2001. The Company no longer has any recorded goodwill or intangible assets that would be subject to amortization or impairment testing.

Had the provisions of SFAS No. 142 been applied retroactively, the Company's net income and net income per share for the three months and six month periods ended June 30, 2002 and 2001, respectively, would have been the pro

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forma amounts indicated below (in thousands, except per share amounts):

	THREE MONTHS ENDED JUNE 30,	
	2002	2001
Net income, as reported	\$ 3,400	\$ 3,588
Add back amortization:		
Real estate - negative goodwill	--	(56)
Textile products - positive goodwill	--	72
Deduct cumulative effect of change in accounting principle:		
Real estate - negative goodwill	--	--
	-----	-----
	--	16
	-----	-----
Net income - pro forma	\$ 3,400	\$ 3,604
	=====	=====
Net income per common share - assuming dilution, as reported	\$ 2.46	\$ 2.48
Adjustments	--	0.01
	-----	-----
Net income per common share - assuming dilution, pro forma	\$ 2.46	\$ 2.49
	=====	=====

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

RESULTS OF OPERATIONS

The Company reported net income of \$3,400,000 for the second quarter ended June 30, 2002, compared to net income of \$3,588,000 in 2001. Net income for the six month periods was \$6,760,000 and \$8,839,000, respectively.

Income from continuing operations was \$1,142,000 in the quarter, compared to a loss of \$1,406,000 in 2001. Revenue from continuing operations for the 2002 second quarter was \$25,833,000, compared to \$21,175,000 in 2001. Income and revenue from continuing operations for the six months in 2002 was \$2,458,000 and \$50,187,000, compared to a loss of \$1,055,000 and \$42,054,000 in 2001.

The Company had been engaged in four business segments - real estate, textile products, energy and hotels. During 2001 the Company sold its energy investment recording an \$8.7 million gain and generating net cash proceeds of \$11.1 million and commenced divestiture of its hotel operations. As of June 30, 2002, the Company had disposed of all of its hotel properties, apart from one

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leased property held for use which it continues to operate. The disposition of the energy and hotel business segments significantly improved the Company's liquidity position by the cash generated from sale of the energy investment and reduction of cash required to fund hotel operations. Future results are largely dependent on the remaining real estate and textile products business segments. Apart from executive level support, both segments operate autonomously utilizing separate management teams and operating systems.

Fee income from real estate operations has remained consistent in recent years, with an occasional spike in lease fees due to the execution of a large lease or development fee due to completion of a major project. Correspondingly, during the same period expenses have been fairly steady, except for the litigation expense in 2001. Cash flow from operations, excluding the litigation expense, was \$4.5 million, \$4.7 million and \$6.8 million, respectively, for the three years ended December 31, 2001. Future cash flows are largely dependent on the leasing, development and management activities of the Company's subsidiaries on behalf of HRP.

The Company continues to face litigation risk related to its real estate operations, as the plaintiff in the aforementioned matter has appealed the court's award of monetary damages and seeks rescission of certain transactions involving HRP's limited partner units as a remedy. An adverse ruling could impact the Company's general partner and limited partner ownership interests and disrupt the Company's cash flow stream.

Textile products sales continues to experience severe competitive pressures from low-cost imports. This industry has been in decline in the United States; however, Brookwood continues to identify new market niches to replace sales lost to importers. In addition to its existing products and proprietary technologies, Brookwood has been developing advanced lightweight, water resistant fabrics which have been well received by its customers. Continued development of these fabrics for military, industrial and consumer applications is a key element of Brookwood's business plan. The ongoing enterprise value of Brookwood is contingent on its ability to adapt to the global textile industry; however, there can be no assurance that the positive results of the past can be sustained.

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

The Company reentered the energy business in January 2002 through a \$1.5 million investment in a newly-formed private energy company, of which the Company holds an approximate 24% equity interest. At the present time this company is in the development stage, having drilled four test wells, the results of which are being analyzed to determine if any of the wells may ultimately become economically feasible to place into commercial production and, if so, to determine the extent of future development.

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

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

REAL ESTATE

The real estate segment reported income of \$1,262,000 for the second quarter and \$2,526,000 for the six month period of 2002, compared to a loss of \$533,000 and income of \$1,437,000 in 2001, respectively.

Revenues. Fee income of \$1,309,000 for the 2002 quarter decreased by \$619,000, or 32%, from \$1,928,000 in 2001. Fee income of \$2,428,000 for the six months decreased by \$1,480,000, or 38%, from \$3,908,000 for the similar period in 2001. Fees are derived from the Company's asset management, property management, leasing and construction supervision services provided to its Hallwood Realty Partners, L.P. affiliate, a real estate master limited partnership ("HRP") and various third parties. The decreases were due primarily to lower leasing and construction supervision fees, which are cyclical in nature, in the 2002 periods.

Equity income from investments in HRP represents the Company's recognition of its pro rata share of net income reported by HRP, adjusted for the elimination of intercompany income. For the 2002 second quarter, the Company reported equity income of \$414,000 compared to \$483,000 in the prior-year period. For the 2002 six months, the equity income was \$947,000, compared to \$1,168,000. The decreases resulted principally from gains from property sales by HRP in 2001, partially offset by decreased litigation costs. The 2001 equity income amounts were exclusive of the Company's \$9,000 pro rata share of HRP's extraordinary loss from early extinguishment of debt and its \$40,000 pro rata share of HRP's loss from cumulative effect of SFAS No. 133 adoption, both of which were reported separately.

Expenses. Administrative expenses of \$293,000 in the 2002 second quarter decreased by \$218,000, or 43%, compared to \$511,000 in 2001. For the six months, the decrease was \$525,000 to \$513,000, from \$1,038,000 in 2001. The decreases were primarily attributable to the payments of commissions associated with leasing income during the 2001 periods.

Amortization expense of \$168,000 for the second quarter, and \$336,000 for the six months in both the 2002 and 2001 periods relates to Hallwood Realty's general partner investment in HRP allocated to management rights, which is being amortized over a ten year period ending in October 2003. At June 30, 2002 there was \$896,000 of unamortized investment remaining.

Litigation expense in 2001 relates to the interest portion of the judgment accrued in June 2001 and paid in October 2001 by the Company to HRP as described in Note 11 to the consolidated financial statements.

TEXTILE PRODUCTS

The textile products segment reported income of \$776,000 and \$1,283,00 for the second quarter and six month periods of 2002, compared to income of \$377,000 and \$27,000 in 2001, respectively.

Revenue. Sales of \$22,931,000 increased by \$4,997,000, or 28%, in the 2002 second quarter, compared to \$17,934,000 in the 2001 quarter. The comparative six month sales increased by \$8,041,000, or 23%, to \$43,752,000 from \$35,711,000 in the 2001 period. The sales increases were principally due to renewed activity in the military business.

During 2001 Brookwood formed a joint venture with an unrelated party that is also in a textile-related industry. The joint venture is 50% owned by each partner who also shares equally the operating and management decision-making.

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Brookwood's investment is accounted for utilizing the equity method of accounting as it does not exercise control over the joint venture. Brookwood's equity income from the joint venture was \$149,000 in the 2002 second quarter and \$723,000 for the six month period, compared to \$101,000 in each of the 2001 periods, respectively.

Expenses. Cost of sales of \$19,151,000 increased by \$4,311,000, or 29%, in the 2002 second quarter, compared to \$14,840,000 in the 2001 second quarter. The comparative six month cost of sales of \$37,204,000 increased by \$7,228,000, or 24%, compared to \$29,976,000. The increases in cost of sales were primarily the result of the increase

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in sales. The lower gross profit margin for the 2002 second quarter (16.5% vs. 17.3%) and the six month periods (15.0% vs. 16.1%) resulted from the sales increase in military business which has lower gross profit margins.

Administrative and selling expenses of \$2,945,000 increased by \$395,000, or 15%, in the 2002 second quarter from \$2,550,000 for the comparable 2001 quarter. The six month amount of \$5,614,000 increased by \$375,000, or 7%, from \$5,239,000 in the comparable 2001 period. The increases resulted primarily from increases in indirect and administrative payroll costs.

Interest expense of \$208,000 decreased by \$60,000, or 22%, in the 2002 second quarter from \$268,000 in 2001. For the six months, interest expense of \$374,000 decreased by \$196,000, or 34%, from \$570,000 for the comparable 2001 period. The decreases were primarily the result of lower interest rates.

OTHER

The other segment reported a loss of \$280,000 for the second quarter of 2002, compared to a loss of \$867,000 in 2001. For the six months, the other segment reported a gain of \$3,000, compared to a loss of \$1,864,000 in 2001. The 2002 three month and six month periods included amortization of deferred revenue from a noncompetition agreement, and 2001 included interest on the former senior secured term loan that was repaid in May 2001.

Revenue. Amortization of deferred revenue was \$604,000 and \$1,208,000 in the 2002 second quarter and six month periods, respectively, compared to \$201,000 in the 2001 second quarter only, which is attributable to the noncompetition fee received in connection with the sale of the Company's investment in Hallwood Energy. The \$7,250,000 noncompete agreement is being amortized over the three year period ending June 2004.

Hotel revenue, which relates entirely to the leased GuestHouse Suites Plus hotel in Huntsville, Alabama that the Company continues to operate, was \$458,000 in the 2002 second quarter and \$898,000 for the six months, compared to \$460,000 and \$892,000 in the respective 2001 periods.

Interest and other income decreased by \$64,000 to \$4,000 for the 2002 second quarter from \$68,000 in 2001. The 2001 second quarter included a gain of \$50,000 on the sale of a miscellaneous investment. The six month amount of \$308,000 increased by \$235,000 from \$73,000 for the comparable 2001 period. The

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increase was attributable to a gain of \$296,000 on the exercise of an option and sale of a marketable security in the 2002 first quarter.

Equity loss of \$36,000 for the quarter and \$77,000 for the six months relates to the Company's pro rata share of loss from HEC's operations which commenced in 2002.

Expenses. Administrative expenses of \$592,000 for the 2002 second quarter increased by \$8,000, from the prior-year amount of \$584,000. For the six months, administrative expenses increased by \$155,000 to \$974,000 from \$819,000 in 2001. The increases are primarily attributable to consulting and other professional fees.

Hotel expenses, which include operating expenses, depreciation and interest costs associated with the GuestHouse Suites Plus hotel in Huntsville, Alabama, increased by \$44,000, or 10%, to \$493,000 in the 2002 second quarter, compared to \$449,000 in 2001. For the six months, hotel expenses increased by \$28,000 to \$930,000 from \$902,000 in 2001. The increases are principally due to an increase in the property's repairs and maintenance expense.

Interest expense in the amount of \$225,000 for the 2002 second quarter decreased by \$338,000 from the prior year amount of \$563,000. For the six months, interest expense decreased by \$879,000 to \$430,000 from \$1,309,000 in 2001. The decreases were primarily due to the May 2001 early extinguishment of the former Senior Secured Term Loan, the repayment of the stockholder loans and imputed interest costs in the 2001 periods associated with the Separation Agreement, partially offset by interest costs on the new Term Loan and Revolving Credit Facility, obtained in March 2002.

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INCOME TAXES

Income taxes relating to continuing operations were \$616,000 for the 2002 second quarter, compared to \$383,000 in 2001. The 2002 quarter included a \$520,000 non cash federal deferred charge, an \$11,000 federal current charge and \$85,000 for state taxes. The 2001 quarter included a \$334,000 non cash federal deferred charge, a \$33,000 federal current (benefit) and \$82,000 for state taxes. Income taxes were \$1,354,000 for the 2002 six month period, compared to \$655,000 in 2001. The six months in 2002 included a deferred tax change of \$1,086,000, a current tax charge of \$23,000 and state tax expense of \$245,000. The 2001 six month amount included a deferred tax charge of \$534,000, a federal current (benefit) of \$12,000 and state tax expense of \$133,000. State tax expense is an estimate based upon taxable income allocated to those states in which the Company does business at their respective tax rates.

As of June 30, 2002, the Company had approximately \$90,000,000 of tax net operating loss carryforwards ("NOLs") and temporary differences to reduce future federal income tax liability. Based upon the Company's expectations and available tax planning strategies, management has determined that taxable income will more likely than not be sufficient to utilize approximately \$13,500,000 of the NOLs prior to their ultimate expiration in the year 2020.

Management believes that the Company has certain tax planning strategies

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

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DISCONTINUED OPERATIONS - HOTELS HELD FOR SALE

In December 2000, the Company decided to discontinue its hotel operations and dispose of its hotel segment, principally by allowing its non-recourse debtholders to assume ownership of the properties through foreclosures or by selling or otherwise disposing of its hotel properties. The Company's former hotel segment consisted of three owned properties and two leased properties. In accordance with accounting standards for reporting discontinued operations, hotel operations apart from the leasehold interest in the GuestHouse Suites Plus hotel in Huntsville, Alabama that the Company continues to operate and has been classified as an asset held for use, have been segregated from the Company's continuing operations and have been reported as a single line item -- Income Loss from Discontinued Operations, which for three months and the six months ended June 30, 2002 and 2001 are presented below (in thousands):

	THREE MONTHS ENDED JUNE 30,	
	2002	2001
	-----	-----
Gain from extinguishment of debt	\$ 3,237	\$ --
Deferred federal income tax (expense)	(925)	--
Sales	67	2,320
	-----	-----
	2,379	2,320
Expenses		
Operating expenses	66	1,829
Interest expense	46	668
Other disposition costs	9	--
Loss reserve (recovery)	--	(166)
	-----	-----
	121	2,331

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Income (loss) from discontinued hotels operations ...	\$ 2,258	\$ (11)
	=====	=====

Revenue. In January 2002, with assistance and consent of the mortgage lender, the Company sold the GuestHouse Suites hotel in Tulsa, Oklahoma for \$3,000,000. The Company received no cash proceeds from the sale. In connection with the sale, the parties entered into a loan modification and assumption agreement which, among other terms, included a release that discharges the Company from any further loan obligation associated with the Tulsa hotel. The Company recognized a gain from extinguishment of debt of \$2,552,000, before a deferred tax charge of \$875,000, in the 2002 first quarter. In February 2002, the mortgage lender for the GuestHouse Suites hotel in Greenville, South Carolina obtained a court judgement of foreclosure. In connection with the foreclosure, the lender waived its right to a deficiency judgement against the Company. The lender completed the foreclosure in June 2002 and the Company recognized a gain from extinguishment of debt in the 2002 second quarter in the amount of \$3,237,000, before a deferred tax charge of \$925,000. Sales of \$67,000 in the 2002 second quarter decreased by \$2,253,000, from the year-ago amount of \$2,320,000. For the six months, the decrease was \$5,661,000 to \$282,000, compared to \$5,943,000 in 2001. The decreases were primarily due to the February 2001 termination of the lease for the Longboat Key Holiday Inn and Suites hotel in Sarasota, Florida and the dispositions of the Oklahoma City, Oklahoma Embassy Suites hotel in June 2001 and Tulsa, Oklahoma GuestHouse Suites hotel in January 2002.

Expenses. Operating expenses of \$66,000 for the 2002 second quarter decreased by \$1,763,000 from \$1,829,000 in 2001. For the six months, operating expenses decreased by \$4,716,000 to \$323,000 from \$5,039,000 in 2001. The decrease is primarily due to the aforementioned dispositions. Interest expense of \$46,000 in the 2002 first quarter decreased by \$622,000 from \$668,000 in 2001 and decreased by \$1,065,000 to \$183,000 from \$1,248,000 for the six months, principally due to principal amortization and debt extinguishment on the various hotel term loans and the interest expense associated with capital leases at the three GuestHouse properties. The disposition costs of \$9,000 for the 2002 second quarter and \$31,000 for the six months are primarily legal costs associated with the disposition of the hotels. Depreciation and amortization expense was not recorded for the periods due to the classification of the hotel operations as a discontinued operation.

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DISCONTINUED OPERATIONS - ENERGY

In March 2001, the Company announced the sale of its investment in its Hallwood Energy affiliate, which represented the Company's energy operations, to Pure Resources II, Inc., an indirect wholly owned subsidiary of Pure Resources, Inc., subject to Hallwood Energy's shareholder approval which was obtained in May 2001. Accordingly, energy operations segregated from the Company's continuing operations have been reported as a single line item - Income from Discontinued Operations. Operations for the three months and six months ended June 30, 2001 are presented below (in thousands):

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	THREE MONTHS ENDED JUNE 30,	
	2002	2001
Gain from disposition of investment in Hallwood Energy	--	\$ 8,725
Deferred income tax (expense) benefit	--	(2,914)
Current income tax (expense)	--	(500)
Equity income from investment in Hallwood Energy	--	495

Income from discontinued energy operations	--	\$ 5,806
		=====

The Company received \$18,000,000 for the tender of its 1,440,000 shares of common stock in May 2001 and recorded a gain of \$8,725,000 from the sale. The Company received an additional amount of \$7,250,000, pursuant to the terms of a noncompetition agreement that was paid by Pure upon the completion of the merger in June 2001, which the Company began amortizing in June 2001 in the other business segment.

The equity income in the 2001 second quarter and six month periods from investment in Hallwood Energy of \$495,000 and \$1,837,000, respectively, represented the Company's pro rata share of income available to common stockholders, and amortization of negative goodwill.

The Company recorded a deferred income tax benefit of \$3,586,000 in the 2001 first quarter, principally due to the anticipated utilization of the Company's NOL's from the anticipated sale of its investment in Hallwood Energy in the 2001 second quarter. In the 2001 second quarter the Company recorded a deferred tax expense of \$2,914,000, current federal tax expense of \$400,000 and state taxes of \$100,000.

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

CUMULATIVE EFFECT OF CHANGES IN ACCOUNTING PRINCIPLES

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

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RELATED PARTY TRANSACTIONS

HRP. The Company's real estate subsidiaries earn asset management, property management leasing and construction supervision fees for their management of HRP's real estate properties. Hallwood Realty earns: (i) an asset management fee equal to 1% of the net aggregate base rents of HRP's properties, (ii) acquisition fees equal to 1% of the purchase price of acquired properties and; (iii) disposition fees equal to 10% of the amount by which the sales price of certain properties exceed the purchase price of such property. Hallwood Realty is also reimbursed for general and administrative costs, at cost, for administrative level salaries and compensation bonuses, employee and director insurance and allocated overhead costs. HCRE earns property management, leasing and construction supervision fees. The management contracts with HRP expires on June 30, 2004 and provide for: (i) a property management fee equal to 2.85% of cash receipts collected from tenants; (ii) leasing fees equal to the current commission market rate as applied to net aggregate rent (none exceeding 6% of the net aggregate rent); and (iii) construction supervision fees for administering construction projects equal to 5% of total construction or tenant improvement costs.

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

	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,	
	2002	2001	2002	2001
Property management fees	\$ 520	\$ 515	\$ 994	\$ 1,030
Leasing fees	464	758	690	1,710
Asset management fees	154	153	309	300
Construction supervision fees	128	431	385	560
Acquisition fees	--	(21)	--	120
	-----	-----	-----	-----
Total	\$ 1,266	\$ 1,836	\$ 2,378	\$ 3,740
	=====	=====	=====	=====

HSC Financial Corporation. The Company has entered into a financial consulting contract with HSC Financial Corporation ("HSC"), a corporation associated with Mr. Anthony J. Gumbiner, the Company's chairman and principal stockholder. The contract provides for HSC to furnish and perform international consulting and advisory services to the Company and its subsidiaries, including strategic planning and merger activities, at a rate of \$795,000 per year (\$495,000 prior to May 2001). HSC is also eligible for bonuses from the Company or its subsidiaries, subject to approval by the Company's board of directors.

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