HALLWOOD GROUP INC
Form 10-Q
May 20, 2008

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

MARK ONE

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

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

FOR THE TRANSITION PERIOD FROM __________ TO __________

For the Period Ended March 31, 2008 **Commission File Number: 1-8303**

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

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

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

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

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

Securities Registered Pursuant to Section 12(g) of the Act:
Title of Class
Series B Redeemable Preferred Stock

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

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

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

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

1,520,666 shares of Common Stock were outstanding at April 30, 2008.

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

	March 31, 2008	December 31, 2007
ASSETS		
Current Assets		
Cash and cash equivalents	$ 5,053	$ 7,260
Accounts receivable, net		
Due from factors	25,672	20,340
Trade and other	6,288	5,521
Related parties	256	249
Inventories, net	25,478	25,028
Federal income tax receivable	12,239	12,239
Deferred income tax, net	971	971
Prepaids, deposits and other assets	543	928
	76,500	72,536
Noncurrent Assets		
Investments in Hallwood Energy, net		
Property, plant and equipment, net	14,352	14,443
Deferred income tax, net	2,822	3,629
Other assets	137	137
	17,311	18,209
Total Assets	$ 93,811	$ 90,745
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Accounts payable	$ 13,590	$ 13,602
Payable additional investment in Hallwood Energy	2,961	5,000
Accrued expenses and other current liabilities	5,050	4,952
State income taxes payable	507	13
Current portion of loans payable	133	158
	22,241	23,725
Noncurrent Liabilities		
Long term portion of loans payable	20,192	17,208
Redeemable preferred stock	1,000	1,000
	21,192	18,208

Total Liabilities		43,433		41,933
Stockholders Equity				
Common stock, issued 2,396,105 shares for both periods; outstanding 1,520,666 shares for both periods		240		240
Additional paid-in capital		56,469		56,469
Retained earnings		7,142		5,576
Treasury stock, 875,439 shares in both periods, at cost		(13,473)		(13,473)
Total Stockholders Equity		50,378		48,812
Total Liabilities and Stockholders Equity	$	93,811	$	90,745

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended March 31,	
	2008	**2007**
Revenues		
Textile products sales	$ 43,987	$ 28,308
Expenses		
Textile products cost of sales	32,552	24,289
Administrative and selling expenses	5,213	4,604
	37,765	28,893
Operating income (loss)	6,222	(585)
Other Income (Loss)		
Investments in Hallwood Energy		
Equity loss	(2,961)	(10,503)
Interest income		12
Interest expense	(247)	(226)
Interest and other income	18	181
	(3,190)	(10,536)
Income (loss) before income taxes	3,032	(11,121)
Income tax expense (benefit)	1,466	(3,797)
Net Income (Loss)	$ 1,566	$ (7,324)
Net Income (Loss) Per Common Share		
Basic	$ 1.03	$ (4.83)
Diluted	$ 1.03	$ (4.83)
Weighted Average Shares Outstanding		
Basic	1,521	1,517
Diluted	1,523	1,517

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended March 31,	
	2008	**2007**
Net Income (Loss)	$ 1,566	$ (7,324)
Other Comprehensive Income (Loss)		
Previously realized increase in fair value of marketable securities sold during the period		(55)
Comprehensive Income (Loss)	$ 1,566	$ (7,379)

See accompanying notes to condensed consolidated financial statements.
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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY
(in thousands)
(unaudited)

	Common Stock		Additional Paid-In	Retained	Treasury Stock		Total Stockholders
	Shares	Par Value	Capital	Earnings	Shares	Cost	Equity
Balance, January 1, 2008	2,396	$ 240	$ 56,469	$ 5,576	875	$ (13,473)	$ 48,812
Net income				1,566			1,566
Balance, March 31, 2008	2,396	$ 240	$ 56,469	$ 7,142	875	$ (13,473)	$ 50,378

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended March 31, 2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	$ 1,566	$ (7,324)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Equity loss from investments in Hallwood Energy	2,961	10,503
Depreciation and amortization	573	509
Deferred tax expense (benefit)	807	(3,836)
Excess tax benefits from share-based payment arrangements		(80)
Proceeds from sale of marketable securities		148
Income from investments in marketable securities		(74)
Changes in assets and liabilities:		
(Increase) in accounts receivable	(6,106)	(1,524)
Increase (decrease) in income taxes receivable/payable	574	(17)
(Increase) decrease in inventories	(450)	(76)
Net change in other assets and liabilities	304	55
Increase (decrease) in accounts payable	303	(763)
Increase in accrued expenses and other current liabilities	98	522
Net cash provided by (used in) operating activities	630	(1,957)
CASH FLOWS FROM INVESTING ACTIVITIES		
Investments in and loans to Hallwood Energy	(5,000)	(5,002)
Investments in property, plant and equipment	(796)	(375)
Net cash used in investing activities	(5,796)	(5,377)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from revolving credit facilities, net	2,984	3,254
Repayment of other bank borrowings and loans payable	(25)	(91)
Purchase of common stock for treasury		(113)
Excess tax benefits from share-based payment arrangements		80
Proceeds from exercise of stock options		34
Net cash provided by financing activities	2,959	3,164
DECREASE IN CASH AND CASH EQUIVALENTS	(2,207)	(4,170)

CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	7,260	10,054
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 5,053	$ 5,884

See accompanying notes to condensed consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Three Months Ended March 31, 2008 and 2007
(unaudited)

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

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

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

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

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

Brookwood Laminating Incorporated (Brookwood Laminating). Brookwood Laminating, located in Connecticut, uses the latest in processing technology to provide quality laminating services for fabrics used in military clothing and equipment, sailcloth, medical equipment, industrial applications and consumer apparel. Up to seven layers of textile materials can be processed using both wet and dry lamination techniques.

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

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

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

In July 2006, Hallwood Energy completed the sale of a 60% undivided working interest in its oil and gas properties in Reeves and Culberson Counties in West Texas and all of its interest in the properties in Parker, Hood and Tarrant Counties in North Texas to Chesapeake Energy Corporation (Chesapeake), which became the operator of these properties.

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

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

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115.* SFAS No. 159 permits entities to choose to measure many financial

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instruments and certain other items at fair value. The FASB believes the statement will improve financial reporting by providing companies the opportunity to mitigate volatility in reported earnings by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Use of the statement will expand the use of fair value measurements for accounting for financial instruments. Although the Company has not yet elected to present any financial assets or liabilities at fair value under SFAS No. 159, it may choose to do so in the future.

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

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

Note 2 Inventories

All inventories relate to Brookwood as of the balance sheet dates (in thousands):

	March 31, 2008	December 31, 2007
Raw materials	$ 8,153	$ 8,084
Work in progress	7,991	8,218
Finished goods	10,164	9,475
	26,308	25,777
Less: Obsolescence reserve	(830)	(749)
Total	$ 25,478	$ 25,028

Note 3 Operations of Brookwood Companies Incorporated

Receivables. Brookwood maintains factoring agreements with several factors, which provide that receivables resulting from credit sales to customers, excluding the U.S. Government, may be sold to the factor, subject to a commission and the factor s prior approval.

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

Sales Concentration. Sales to one Brookwood customer, Tennier Industries, Inc. (Tennier), accounted for more than 10% of Brookwood s sales during both the 2008 and 2007 periods. Its relationship with Tennier is ongoing. Sales to Tennier, which are included in military sales, were $14,868,000 in the 2008 first quarter, compared to $6,895,000 in the 2007 first quarter, which represented 33.8% and 24.4% of Brookwood s sales, respectively. Sales to another customer, ORC Industries, Inc. (ORC), accounted for more than 10% of Brookwood s sales in 2006. Its relationship with ORC is ongoing. Sales to ORC, which are included in military sales, were $4,029,000, in the 2008 first quarter, compared to $2,206,000 in the 2007 first quarter, which represented 9.2% and 7.8% of Brookwood s sales, respectively.

Military sales accounted for $28,158,000 and $12,036,000 in the 2008 and 2007 first quarters, which represented 64.0% and 42.5% of Brookwood s sales, respectively.

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Stockholders Equity. The Company is the holder of all of Brookwood s outstanding $13,500,000 Series A, $13.50 annual dividend per share, redeemable preferred stock and all of its 10,000,000 outstanding shares of common stock. The preferred stock has a liquidation preference of $13,500,000 plus accrued but unpaid dividends. At March 31, 2008, cumulative dividends in arrears on the preferred stock amounted to approximately $5,009,000.

2005 Long-Term Incentive Plan for Brookwood. In December 2005, the Company adopted The Hallwood Group Incorporated 2005
Long-Term Incentive Plan for Brookwood Companies Incorporated (the 2005 Long-Term Incentive Plan for Brookwood) to encourage employees of Brookwood to increase the value of Brookwood and to be employed by Brookwood. The terms of the incentive plan provide for a total award amount to participants equal to 15% of the fair market value of consideration received by the Company in a change of control transaction, as defined, in excess of the sum of the liquidation preference plus accrued unpaid dividends on the Brookwood preferred stock (approximately $18,509,000 at March 31, 2008). The base amount will fluctuate in accordance with a formula that increases by the amount of the annual dividend on the preferred stock, currently $1,823,000, and decreases by the amount of the actual dividends paid by Brookwood to the Company. However, if the Company s board of directors determines that certain specified Brookwood officers, or other persons performing similar functions do not have, prior to the change of control transaction, in the aggregate an equity or debt interest of at lease two percent in the entity with whom the change of control transaction is completed, then the minimum amount to be awarded under the plan shall be $2,000,000. In addition, the Company agreed that, if members of Brookwood s senior management do not have, prior to a change of control transaction in the aggregate an equity or debt interest of at least two percent in the entity with whom the change of control transaction is completed (exclusive of any such interest any such individual receives with respect to his or her employment following the change of control transaction), then the Company will be obligated to pay an additional $2,600,000.

Engagement of Financial Advisor. In December 2007, a special committee of the board of directors of the Company engaged a financial advisor to assist it in developing and considering the Company s strategic alternatives, including a potential sale, with respect to Brookwood. There can be no assurance that the special committee will recommend that the Company take any action with respect to Brookwood, or that any transaction will be completed.

Note 4 Investments in Hallwood Energy, L.P.

Investments in Hallwood Energy as of the balance sheet dates were as follows (in thousands):

	As of March 31, 2008		Amount at which carried at		Income (loss) for the three months ended	
	Percent of Class		March 31,	December 31,	March 31,	
Description	**Owned**	**Cost**	**2008**	**2007**	**2008**	**2007**
- Class A limited partner interest	25%(a)	$ 50,384	$	$	$	$ (10,502)
- Class C limited partner interest	13%	11,084				
- General partner interest	50%	13				(1)
- Convertible Notes	25%	7,961			(2,961)	
Total		$ 69,442	$	$	$ (2,961)	$ (10,503)

(a) 18% after consideration of profit interests

The Company accounts for this investment using the equity method of accounting and records its pro rata share of Hallwood Energy s net income (loss) and partner capital transactions, as appropriate.

Hallwood Energy is a privately held independent oil and gas limited partnership and operates as an upstream energy company engaging in the acquisition, development, exploration, production, and sale of hydrocarbons, with a primary focus on natural gas assets. Hallwood Energy conducts its energy activities from its corporate office located in Dallas, Texas and production offices in Searcy, Arkansas and Lafayette, Louisiana. Hallwood Energy s results of operations are and will be largely dependent on a variety of factors, including, but not limited to fluctuations in natural gas prices; success of its drilling activities; the ability to transport and sell its natural gas; regional and national regulatory matters; the ability to secure, and price of, goods and services necessary to develop its oil and gas leases; and the ability to raise additional capital.

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Hallwood Energy s management has classified its energy investments into three identifiable geographical areas:

- West Texas the Barnett Shale and Woodford Shale formations,
- Central and Eastern Arkansas primary target is the Fayetteville Shale formation, and
- South Louisiana various projects on and around the LaPice Salt Dome.

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

In January 2008, the Company loaned $5,000,000 to Hallwood Energy as part of a $30,000,000 convertible subordinated note agreement (discussed below).

The Company s proportionate share of Hallwood Energy s calendar year 2007 loss would have reduced the carrying value of its investment in Hallwood Energy below zero. The general rule for recording equity losses ordinarily indicates that the investor shall discontinue applying the equity method when the investment has been reduced to zero and shall not provide for additional losses unless the investor provides or commits to provide additional funds in the investee, has guaranteed obligations of the investee, or is otherwise committed to provide further financial support to the investee. Although no guarantee or commitment existed at December 31, 2007, the Company loaned $5,000,000 to Hallwood Energy in January 2008 in connection with Hallwood Energy s issuance of up to $30,000,000 of convertible subordinated notes due January 21, 2011 to provide capital to continue regular ongoing operations. Accordingly, the Company recorded an additional equity loss in 2007 to the extent of the $5,000,000 loan, as the Company had not determined to what extent, if any, that it would advance additional funds to Hallwood Energy.

Potential Transaction. As previously disclosed, Hallwood Energy is in the process of seeking additional capital from external sources. This effort is continuing, but financing has not yet been obtained. Hallwood Energy is in the process of negotiating a transaction that would provide additional capital. However, there is no assurance that any such transaction will be completed. If Hallwood Energy is unable to obtain additional funds in the near future, there is substantial doubt about Hallwood Energy s ability to continue as a going concern. The Company s management has indicated that it does not currently intend to make additional investments in Hallwood Energy, except in connection with Hallwood Energy s obtaining additional funds from external sources.

In connection with the potential transaction, the Company loaned $2,961,000 on May 15, 2008 to Hallwood Energy subject to the same terms as the Convertible Notes. Due to the uncertainties related to the completion of the potential transaction and the Company s additional investment, if any, the Company recorded an equity loss for the 2008 first quarter to the extent of the $2,961,000 loan. The Company s carrying value of its Hallwood Energy investment is zero at March 31, 2008, and its proportionate share of Hallwood Energy s accumulated losses that have not been recorded is approximately $2,587,000.

A description of Hallwood Energy s activities during 2007 and 2008 are provided below.

Loan Financing. In February 2006, Hallwood Energy entered into a $65,000,000 loan facility (the Former Loan Facility), and had drawn $40,000,000 as of December 31, 2006. Subsequent to December 31, 2006, Hallwood Energy was not in compliance with the proved collateral coverage ratio required by the Former Loan Facility.

In March and April 2007, the Company loaned a total of $9,000,000 to Hallwood Energy, of which $7,000,000 was in the form of demand notes bearing interest at 6% above prime rate, and $2,000,000 was an advance that was repaid four days later with interest. In April 2007, Hallwood Energy made a request for additional capital contributions in the amount of $25,000,000 (the April Call). The Company and Hallwood Energy had agreed that the $7,000,000 of loans would be applied as the Company s portion of the April Call and as such was recorded as a Class C partnership investment. In May 2007, Hallwood Energy repaid $257,000 to the Company, which represented the excess of the $7,000,000 loaned over the Company s share of the capital contribution and related oversubscription.

In April 2007, Hallwood Energy entered into a $100,000,000 loan facility (the Senior Secured Credit Facility) with a new lender (the New Lender), who is an affiliate of one of Hallwood Energy s investors and drew $65,000,000 from the Senior Secured Credit Facility. The proceeds were used to repay the $40,000,000 balance of the Former Credit Facility, approximately

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Three Months Ended March 31, 2008 and 2007
(unaudited)

$9,800,000 for a make-whole fee and approximately $500,000 for incremental interest related to Former Credit Facility, transaction fees of approximately $200,000 and provide working capital. The Senior Secured Credit Facility is secured by Hallwood Energy s oil and gas leases, matures on February 1, 2010, and bears interest at a rate of the defined LIBOR rate plus 10.75% per annum. An additional 2% of interest is added upon continuance of any defaulting event. 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. In conjunction with executing the Senior Secured Credit Facility, the New Lender resigned its position on Hallwood Energy s board of directors and assigned its general partner interest to the remaining members.

The Senior Secured Credit Facility provided that, if Hallwood Energy raised $25,000,000 through an equity call or through debt subordinate to the Senior Secured Credit Facility, the New Lender would match subsequent amounts raised on a dollar for dollar basis up to the remaining $35,000,000 under the Senior Secured Credit Facility through the availability termination date of July 31, 2008. During the 2007 third quarter, Hallwood Energy borrowed an additional $20,000,000 under the Senior Secured Credit and borrowed the remaining $15,000,000 availability in October 2007. Accordingly, the Senior Secured Credit Facility was fully funded with an outstanding balance of $100,000,000 at
December 31, 2007.

The Senior Secured Credit Facility contains various financial covenants, including maximum general and administrative expenses and current and proved collateral coverage ratios. The proved collateral coverage ratio test is effective 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. In October 2007, Hallwood Energy entered into an amendment of the Senior Secured Credit Facility to modify the calculation of the current ratio to include certain capital funding commitments.

The Senior Secured Credit Facility contains a make-whole provision whereby Hallwood Energy is required to pay the New Lender the amount by which the present value of interest and principal from the date of prepayment through January 31, 2009, exceeds the principal amount on the prepayment date. The New Lender received warrants exercisable for 2.5% of the partnership interests at an exercise price of 2.5% of 125% of the amount of the total capital contributed to Hallwood Energy at December 31, 2006.

In January 2008, Hallwood Energy entered into a $30,000,000 convertible subordinated note agreement (the Convertible Note). The Convertible Note bears interest which accrues at an annual rate of 16%, which is payable on a quarterly basis after the completion of a defined equity offering and subject to the prior full payment of borrowings and accrued interest under the Secured Credit Facilities. The Convertible Note and accrued interest may be converted into Class C interests on a dollar for dollar basis. If no Class C interests are outstanding, the Convertible Note may be converted into Class A interests or such comparable securities as may be outstanding at the same exchange ratio as the original Class C interests. Principal and unpaid interest are due on the earlier of January 21, 2011, or upon a defined change of control.
A change of control redemption may also result in a make-whole provision whereby Hallwood Energy would pay a premium based on the difference between either $48,300,000 or $45,500,000 and the sum of previously made Convertible Note principal and accrued interest payments. As of March 31, 2008, $28,839,000 of the Convertible Notes had been subscribed for and issued. The Company subscribed and purchased $5,000,000 of the Convertible Note in January 2008.

The Convertible Note lenders also received warrants exercisable at up to $3,750,000 for an equal dollar amount of Class C interests, or such comparable securities as are outstanding at the time of exercise at the same exchange ratio as the original Class C interests. The warrants are exercisable until January 21, 2011.

In January 2008, Hallwood Energy entered into the $15,000,000 Junior Credit Facility with the New Lender and drew the full amount of the facility. Proceeds were used to fund working capital requirements and future operational activities. Borrowings under the facilities are both secured by Hallwood Energy s oil and gas leases, mature on February 1, 2010, and bear interest at a rate of the defined LIBOR rate plus 10.75% per annum through April 30, 2008, thereafter increases to 12.75% per annum until loan maturity or prepayment. An additional 2% of interest is added upon continuance of any defaulting event. 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. Hallwood Energy remains bound to a deposit control agreement initiated with the Senior Secured Credit Facility.

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The Junior Credit Facility contains various financial covenants, materially consistent with the Senior Secured Credit Facility, including maximum general and administrative expenditures and current and proved collateral coverage ratios. The proved collateral coverage ratio covenant becomes effective June 30, 2008. 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 Hallwood Energy s activities.

The Junior Credit Facility contains a make-whole provision whereby Hallwood Energy is required to pay the New Lender the amount by which the present value of interest and principal from the date of prepayment through January 31, 2009, exceeds the principal amount on the prepayment date.

In connection with the Junior Credit Facility, the Senior Secured Credit Facility was amended to bear interest at the defined LIBOR rate plus 12.75% per annum beginning May 1, 2008.

Hallwood Energy did not meet the current ratio covenant and was in default of the Senior Secured Credit Facility as of December 31, 2007.
A second default event related to a commitment agreement by three partners to fund $15,000,000 by November 1, 2007, that was only partially funded. Hallwood Energy received a waiver from the New Lender for both of these default events in January 2008.

Hallwood Energy is not in compliance with the general and administrative expense covenant at March 31, 2008 and current ratio covenant as of April 30, 2008 required by the Senior Secured Credit Facility and the Junior Credit Facility and has entered into discussions with the New Lender to waive the current default and amend by extending this covenant test into a future period. This amendment is being discussed with the New Lender in conjunction with a potential transaction that would provide financial resources to meet this covenant test for the next 12 months.

Senior Secured Credit Facility borrowings have been included in current liabilities on Hallwood Energy s balance sheet at December 31, 2007, as Hallwood Energy does not expect to maintain compliance with the required current and proved collateral coverage ratios during the year ended December 31, 2008, unless additional funds are raised through issuance of debt and equity instruments.

Equity Investments. There are currently three classes of limited partnership interests held in Hallwood Energy:

Class C interests bear a 16% priority return which compounds monthly. The priority return will be accrued and become payable when, as and if declared by the general partner of Hallwood Energy. Hallwood Energy does not anticipate paying any distributions in the foreseeable future. All distributions of defined available cash and defined net proceeds from any sales or other disposition of all or substantially all of the then remaining assets of Hallwood Energy which is entered into in connection with, or which will result in, the liquidation of Hallwood Energy (the Terminating Capital Transaction) must first be used to reduce any unpaid Class C priority return and capital contributions to zero. Unpaid Class C priority return and capital contributions can be converted into Class A interests based on the ratio of Class C contributions to the sum of Class A contributions and the Class C limited partner s Class C partnership interest designated by the Class C limited partner to be converted into Class A partnership interest. The Class C capital contributions were $84,422,000 and unpaid priority returns were $9,505,000 at March 31, 2008.

Class A interests have certain voting rights and with the general partner would receive 100% of the distributions of available cash and net proceeds from Terminating Capital Transactions subsequent to the payment of all unpaid Class C priority return and of all Class C capital contributions until the unrecovered capital accounts of each Class A partner interest is reduced to zero, and thereafter share in all future distributions of available cash and net proceeds from Terminating Capital Transactions with the holders of the Class B interests.

Class B interests represent vested net profit interests awarded to key individuals by Hallwood Energy. At March 31, 2008 and December 31, 2007, outstanding Class B interests had rights to receive 20.0% and 18.6%, respectively, of distributions of defined available cash and net proceeds from Terminating Capital Transactions after the unpaid Class C priority return and capital contributions and the unreturned Class A and general partner capital contributions have been reduced to zero.

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In April 2007, Hallwood Energy issued a $25,000,000 Class C equity call to its partners (the April Call) which was fully satisfied. Previously, Hallwood Energy received loans of $7,000,000 each from the Company and an affiliate of the New Lender. These loans were applied to the April Call. In May 2007, Hallwood Energy repaid $257,000 to the Company, which represented the excess of its $7,000,000 advanced over the Company s share of the capital contribution and related oversubscription.

In April 2007, Hallwood Investments Limited (HIL), a corporation associated with Mr. Anthony J. Gumbiner, the Company s chairman and principal stockholder, and the New Lender each committed to fund one-half of the April Call and potential additional equity or subordinated debt funding calls totaling $55,000,000 by Hallwood Energy, to the extent other investors, including the Company, did not respond to equity calls.

In May 2007, Hallwood Energy issued a $20,000,000 Class C equity call to its partners (the May Call), which was fully satisfied. The Company s proportionate share of the May Call was $5,091,000. Due to the fact that the Company did not have available sufficient cash, the Company contributed only $2,501,000 towards the May Call. Because of the Company s inability to meet its full equity call requirement, HIL funded $2,591,000 of the May Call that was not funded by the Company. In connection with the funding of this amount, Mr. Gumbiner agreed with a special committee of the board of directors of the Company that he would discuss the terms of this investment in the future.

In August 2007, Hallwood Energy issued a $15,000,000 Class C equity call to its partners (the August Call) which was fully satisfied. The Company s proportionate share of the August Call was $3,683,000. Due to the fact that the Company did not have available sufficient cash, the Company contributed only one-half, or $1,842,000, towards the August Call. Because of the Company s inability to meet its full equity call requirement, HIL funded $1,842,000 of the August Call that was not funded by the Company. In October 2007, the special committee appointed to consider HIL s funding of these capital calls acknowledged the terms of the funding of the capital calls by HIL and determined that, in light of the circumstances, including the Company s present inability to fund any amounts beyond those it had made, no further action was required.

As a result of the receipt of sufficient equity contributions from the April, May and August Calls, the $55,000,000 commitment from HIL and the New Lender was extinguished.

In November 2007, Hallwood Energy issued $15,000,000 of Class C partnership interest to a new equity partner. In addition, HIL, another existing investor in Hallwood Energy, and the New Lender entered into a letter agreement providing for a total of up to $15,000,000 in additional funding. Under the terms of this letter, HIL agreed to advance $7,500,000 and the other investor agreed to advance $3,000,000 to Hallwood Energy no later than November 15, 2007. These advances constituted loans to Hallwood Energy with an interest rate of 16% per annum and a maturity of March 1, 2010. The letter agreement contained a provision that permitted Hallwood Energy to repay the advances at any time without penalty in connection with a recapitalization of Hallwood Energy providing for net proceeds not less than the amount being repaid. If any part of these advances remained outstanding on January 2, 2008, then on that date the outstanding amount would automatically be converted into preferred partnership interests having the same terms as the existing class of preferred partnership interests. In addition, if any portion of the advances was converted into preferred partnership interests on January 2, 2008, then the New Lender agreed to contribute to Hallwood Energy the same proportion of $4,500,000 in exchange for preferred partnership interests. Hallwood Energy also agreed that if any portion of the agreed funding from HIL or the other existing investor was not made, it would be an event of default under the Senior Secured Credit Facility. HIL advanced $7,500,000 in November 2007, although the other investor did not fulfill its commitment. On January 2, 2008, as per the letter agreement, HIL s loan was converted into a Class C interest.

Litigation. In early 2006, Hallwood Energy and Hallwood Petroleum entered into two two-year contracts with Eagle Drilling, LLC (Eagle Drilling), under which the contractor was to provide drilling rigs and crews to drill wells in Arkansas at a daily rate of $18,500, plus certain expenses for each rig (the Contracts). These Contracts were subsequently assigned by Eagle Drilling, LLC to Eagle Domestic Drilling Operations, LLC (Eagle Domestic), on or about August 24, 2006. Before that, on or about August 14, 2006, one of the masts on the rigs provided under the

Contracts collapsed. Hallwood Energy and Hallwood Petroleum requested the contractor to provide assurances that the mast on the other rig, and any mast provided to replace the collapsed mast, were safe and met the requirements of the Contracts. When the contractor refused to provide assurances, Hallwood Energy and Hallwood Petroleum notified the contractor that the Contracts were terminated and on September 6, 2006, filed *Hallwood Petroleum, LLC and Hallwood Energy, L.P. v. Eagle Drilling, LLC and Eagle Domestic Drilling Operations, LLC,* in the 348th District Court of Tarrant County, Texas to recover approximately $1,688,000 previously deposited with the contractor under the Contracts. Since then, Eagle Domestic and its parent filed for Chapter 11 bankruptcy protection in
Case No. 07-30426-H4-11,

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Jointly Administered Under Case No. 07-30424-H4-11, in the United States District Court for the Southern District of Texas. After the filing of its bankruptcy case, Eagle Domestic filed an adversary action on June 11, 2007 against Hallwood Energy and Hallwood Petroleum in the bankruptcy proceeding to recover unspecified damages, but purportedly in excess of $50,000,000 (the Eagle Domestic Adversary), based on disclosures made during the discovery phase of the case. Eagle Domestic contends that Hallwood Energy and Hallwood Petroleum breached the Contracts, tortiously interfered with Eagle Domestic s contracts with Quicksilver Resources and disparaged Eagle Domestic. Hallwood Energy subsequently filed its answer and counterclaim in the Eagle Domestic Adversary asserting that Hallwood Energy owes nothing to Eagle Domestic, and that Eagle Domestic owes Hallwood approximately $1,688,000 in unearned pre-payment under the Contracts.

On April 3, 2008, Hallwood Energy and Eagle Domestic signed an agreement to settle the litigation between them. Under the agreement, Hallwood Energy will pay to Eagle Domestic $2,000,000 in cash and issue to Eagle Domestic $2,750,000 in equity of Hallwood Energy or a successor entity. Hallwood Energy may defer the payment of the cash and issuance of the equity until the later of the completion of a major financing, or June 30, 2008. If the major financing is in the form of an Initial Public Offering, Hallwood Energy will deliver to Eagle Domestic shares of stock. Hallwood Energy will make best efforts to deliver registered shares. If the shares cannot be registered, Hallwood Energy will deliver shares that will be freely tradeable in their principal market within 90 days of the delivery. If the major financing is in the form of a private partnership or joint venture, Hallwood Energy will deliver partnership units to Eagle Domestic. If prior to June 30, 2008, Hallwood Energy or a successor entity has not completed a major financing, but has received bridge financing in the aggregate at least $20,000,000, then Hallwood Energy will pay to Eagle Domestic $500,000 in cash. The payment of $500,000 in cash will extend the date referred to above to September 30, 2008 and will be credited against the $2,000,000 payment if the $2,000,000 cash payment and $2,750,000 in equity is received no later than September 30, 2008. If the $2,000,000 cash payment and $2,750,000 in equity is not received by September 30, 2008, then the $500,000 cash will not be credited against any future judgment or settlement of the proceeding. The trial previously set in the matter will be continued until not earlier than September 30, 2008 and, upon receipt of the amounts contemplated by the settlement agreement, all parties and their affiliates will be fully and finally mutually released from any and all claims the other parties and their affiliates may have.

In October 2006, Eagle Drilling filed a related lawsuit against Hallwood Energy and Hallwood Petroleum in Oklahoma state court (the Eagle Drilling Action) alleging damages of over $1,000,000 in connection with unpaid invoices, unpaid downtime and other damages caused as a result of the mast collapsing. On September 20, 2007, Eagle Drilling filed for Chapter 11 bankruptcy protection in the United States Bankruptcy Court for the Western District of Oklahoma. The Eagle Drilling Action and the Tarrant County Action were converted to adversary proceedings in the Oklahoma Bankruptcy Court and both adversary proceedings were consolidated under one proceeding (the Consolidated Adversary), which would be adjudicated in the context of a jury trial to be conducted by the Oklahoma Bankruptcy Court to commence in September 2008. Hallwood Energy has also brought a claim against Eagle Drilling for return of the approximately $1,688,000 in unearned pre-payment from Eagle Drilling. On April 7, 2008, Eagle Drilling filed its Motion for Leave to File Amended Complaint in the Consolidated Adversary, seeking to add breach of contract claims to the Consolidated Adversary proceeding against Hallwood Energy and Hallwood Petroleum which were asserted by Eagle Domestic in the Eagle Domestic Adversary, which claims Hallwood Energy and Hallwood Petroleum believes will be conclusively resolved pursuant to the settlement with Eagle Domestic described above. The damages alleged under the claims which Eagle Drilling seeks to add are purportedly in excess of $20,000,000. Hallwood Energy and Hallwood Petroleum have filed an Objection to Eagle Drilling s Motion for Leave to Filed Amended Complaint and have filed a Motion for Leave to File First Amended Complaint in the Consolidated Adversary Proceeding, seeking to assert fraud and fraudulent inducement claims against Eagle Drilling. Hearings have not been set to hear these motions. Instead, the Oklahoma Bankruptcy Court will first consider a

Motion to Convert the Eagle Drilling Case to one under Chapter 7 of the Bankruptcy Code, filed by Quicksilver Resources, Inc. (and joined by Hallwood Energy and Hallwood Petroleum) at a hearing scheduled for May 20, 2008.

On May 13, 2008, Eagle Domestic filed an Emergency Motion for Order to Enforce Orders Confirming Plan and Approving Compromise of Controversies and in the Alternative to Show Cause Why Eagle Drilling, LLC Should Not Be Held in Contempt of Same (the Motion to Enforce) in the Houston Bankruptcy Court, seeking a ruling from the Houston Bankruptcy Court that Eagle Drilling is in violation of Eagle Domestic s property rights by attempting to assert the claims which Eagle Drilling seeks to add in the Eagle Drilling Adversary by virtue of the Motion for Leave. The Motion to Enforce is currently set for hearing in the Houston Bankruptcy Court for May 21, 2008.

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The following table sets forth summarized financial data for Hallwood Energy, L.P. (in thousands):

	March 31, 2008	December 31, 2007
Balance Sheet Data		
Cash and cash equivalents	$ 4,419	$ 2,372
Oil and gas properties, net	133,137	107,248
Total assets	148,393	115,678
Notes payable	133,750	101,990
Total liabilities	182,019	146,516
Partners capital (deficiency)	(33,626)	(30,838)

	Three Months Ended March 31, 2008	2007
Statement of Operations Data		
Revenues		
Natural gas sales	$ 4,235	$
Facility income	328	
	4,563	
Expenses		
Impairment of oil and gas properties		31,680
Operating expenses (including litigation settlement of $4,750 in 2008)	5,439	4
General and administrative expenses	4,088	1,659
Depreciation and depletion	2,027	63
	11,554	33,406
Operating Loss	(6,991)	(33,406)
Other Income and Expense		
Interest expense	(3,359)	(8,527)
Interest income	62	134
	(3,297)	(8,393)
Net Loss	$ (10,288)	$ (41,799)

Note 5 Loans Payable

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

	March 31, 2008	December 31, 2007
Working capital revolving credit facility, interest at Libor +1.25% - 1.75% or prime, due January 2010	$ 20,185	$ 17,181
Equipment term loans, interest at various rates; due at various dates through April 2009	140	185
Total	20,325	17,366
Current portion	(133)	(158)
Noncurrent portion	$ 20,192	$ 17,208

Working Capital Revolving Credit Facility. The Company s Brookwood subsidiary has a revolving credit facility in an amount up to $25,000,000 (increased from $22,000,000 in December 2007) with Key Bank National Association (the Working Capital Revolving Credit Facility). Borrowings are collateralized by accounts receivable, certain finished goods inventory,

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machinery and equipment and all of the issued and outstanding capital stock of Brookwood and its subsidiaries. The facility bears interest at Brookwood s option of Prime, or Libor plus 1.25% - 1.75% (variable depending on compliance ratios) and contains various covenants. The interest rate was a blended rate of 4.63% and 6.73% at March 31, 2008 and December 31, 2007, respectively. The outstanding balance was $20,185,000 at March 31, 2008 and Brookwood had $4,815,000 of borrowing availability under this facility.

Equipment Term Loans. Brookwood has a revolving equipment credit facility in an amount up to $3,000,000 with Key Bank. Interest rates for the equipment loans varied between 4.36% and 8.20%, with a blended rate of 5.06% and 6.53% at March 31, 2008 and December 31, 2007, respectively. The outstanding balance at March 31, 2008 was $140,000 and Brookwood had $2,860,000 of borrowing availability under this facility.

Loan Covenants. The Working Capital Revolving Credit Facility provides for a maximum total debt to tangible net worth ratio and a covenant that Brookwood shall maintain a quarterly minimum net income of not less than one dollar. Cash dividends and tax sharing payments to the Company are contingent upon Brookwood s compliance with the covenants contained in the loan agreement. As of the end of all interim periods in 2008 and 2007 and as of December 31, 2007, Brookwood was in compliance with its principal loan covenants, although a waiver regarding a pro forma (inclusive of projected dividend) total debt to tangible net worth ratio for the 2007 third quarter was granted to allow a $1,500,000 dividend payment in November 2007.

Restricted Net Assets. Cash dividends and tax sharing payments by Brookwood to the Company are contingent upon compliance with the Key Bank loan covenants. This limitation on the transferability of assets constitutes a restriction of Brookwood s net assets, which were $31,974,000 and $29,180,000 as of March 31, 2008 and December 31, 2007, respectively.

Note 6 Stockholders Equity

Stock Options. The Company established the 1995 Stock Option Plan for The Hallwood Group Incorporated which authorized the granting of nonqualified stock options to employees, directors and consultants of the Company. The 1995 Plan authorized options to purchase up to 244,800 shares of common stock of the Company. The exercise prices of all options granted were at the fair market value of the Company s stock on the date of grant, had an expiration date of ten years from date of grant and were fully vested on the date of grant.

At March 31, 2008, there were 4,500 fully vested outstanding options that expire in May 2010. The 1995 Stock Option Plan terminated on June 27, 2005. Options issued prior to the termination were not affected, however, no new options can be issued under the 1995 Plan.

In January 2007, one officer of the Company exercised options to purchase 2,250 shares of the Company s common stock that were scheduled to expire in February 2007. The officer paid the exercise price and related tax withholding requirement by exchanging an equivalent number of common shares valued at the fair market value of the common stock at the date of exercise. The net result of the exercise and exchange was the reissuance of 1,273 shares from treasury at an average carrying value of $14.97 per share.

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Option activity for the quarter ended March 31, 2008 and status of outstanding options are as follows:

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding, January 1, 2008	4,500	$ 10.31		
Granted				
Exercised				
Forfeited				
Outstanding, March 31, 2008	4,500	$ 10.31	2.17	$ 233,000
Options exercisable and vested at March 31, 2008	4,500		2.17	$ 233,000

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company s closing stock price on the last trading day of the 2008 first quarter ($62.03 per share) and the exercise price, multiplied by the number of options).

Note 7 Income Taxes

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

	Three Months Ended March 31, 2008	2007
Federal		
Current	$	$
Deferred	807	(3,794)
Sub-total	807	(3,794)
State		
Current	659	40
Deferred		(43)
Sub-total	659	(3)
Total	$ 1,466	$ (3,797)

The net deferred tax asset was $3,793,000 and $4,600,000 at March 31, 2008 and December 31, 2007, respectively. The deferred tax asset at March 31, 2008 was comprised of $1,720,000 attributable to temporary differences, that upon reversal, can be utilized to offset income from operations, $1,229,000 attributable to a net operating loss carryforward from 2007, and $844,000 of alternative minimum tax credits. The December 31, 2007 amount was attributable to temporary differences of $1,720,000, a net operating loss carryforward of $2,036,000 and $844,000 of alternative minimum tax credits. The effective federal tax rate in both periods was 34%, while state taxes were determined based upon taxable income apportioned to those states in which the Company does business at their respective tax rates.

The federal income tax receivable, attributable to the anticipated carryback of its 2007 taxable loss, was $12,239,000 at March 31, 2008 and December 31, 2007. The Company expects to file a carryback of its 2007 taxable loss to obtain the refund in September 2008.

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Note 8 Supplemental Disclosures to the Condensed Consolidated Statements of Cash Flows

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

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

Description	Three Months Ended March 31, 2008	2007
Change in payable additional investment in Hallwood Energy	$ 2,961	$
Income tax effect from exercise of stock options:		
Income taxes payable	$	$ 80
Additional paid-in capital		(80)
	$	$
Increase (decrease) in accrued capital expenditures in accounts payable	$ (314)	$ 107
Previously realized increase in fair value of marketable securities sold during the period	$	$ (55)

***Supplemental disclosures of cash payments*:**

	2008	2007
Income taxes paid	$ 96	$ 65
Interest paid	257	204

Note 9 Computation of Income (Loss) Per Common Share

The following table reconciles weighted average shares outstanding from basic to diluted and reconciles net income (loss) used in the computation of income (loss) per share for the basic and diluted methods (in thousands):

Description	Three Months Ended March 31, 2008	2007
Weighted Average Shares Outstanding		
Basic	1,521	1,517
Potential shares from assumed exercise of stock options	4	
Potential repurchase of shares from stock option proceeds	(2)	
Diluted	1,523	1,517
Net Income (Loss)		
Basic and diluted	$ 1,566	$ (7,324)

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Due to the loss for the three months ended March 31, 2007, potential shares from assumed exercise of stock options in the amount of 7,000 shares were antidilutive.

Note 10 Litigation, Contingencies and Commitments

Reference is made to Note 16 to the consolidated financial statements contained in Form 10-K for the year ended December 31, 2007.

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

On July 31, 2007, Nextec Applications, Inc. filed *Nextec Applications, Inc. v. Brookwood Companies Incorporated and The Hallwood Group Incorporated* in the United States District Court for the Southern District of New York (SDNY No. CV 07-6901) claiming that the defendants infringed five United States patents pertaining to internally-coated webs: U.S. Patent No. 5,418,051; 5,856,245; 5,869,172; 6,071,602 and 6,129,978. On October 3, 2007, the U.S. District Court dismissed The Hallwood Group Incorporated from the lawsuit. Brookwood has answered the lawsuit and intends to vigorously defend these claims.

Hallwood Energy. As a significant investor in Hallwood Energy, the Company may be impacted by litigation involving Hallwood Energy. Refer to Note 4 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, Brookwood received a Notice of Alleged Violation from The Rhode Island Department of Environmental Management (RIDEM) with notification that Brookwood had failed to comply timely with a requirement to test the destruction efficiency of a thermal oxidizer at its Kenyon plant and that when the test was conducted the equipment was not operating at the required efficiency. Since that time, Brookwood has upgraded and retested the equipment, which met the requirements on the retest. RIDEM has requested additional information regarding the failed test and Brookwood s remedial actions, 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 in March 2007, a consent agreement was executed and a $9,500 fine was remitted to RIDEM to close this matter.

In June 2007, RIDEM issued a NOV to Kenyon alleging that the Company violated certain provisions of its wastewater discharge permit and seeking an administrative penalty of $79,000. Kenyon filed an Answer and Request for Hearing to dispute certain allegations in the NOV and the amount of the penalty. The informal meeting was held in August 2007 and settlement negotiations are ongoing.

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Note 11 Segments and Related Information

The following represents the Company s reportable segment operations for the three months ended March 31, 2008 and 2007, respectively (in thousands):

	Textile Products	Energy	Other	Consolidated
Three months ended March 31, 2008				
Total revenue from external sources	$ 43,987			$ 43,987
Operating income (loss)	$ 7,403	$	$ (1,181)	$ 6,222
Other income (loss), net	(247)	(2,961)	18	(3,190)
Income (loss) before income taxes	$ 7,156	$ (2,961)	$ (1,163)	$ 3,032
Three months ended March 31, 2007				
Total revenue from external sources	$ 28,308			$ 28,308
Operating income (loss)	$ 498	$	$ (1,083)	$ (585)
Other income (loss), net	(226)	(10,491)	181	(10,536)
Income (loss) before income taxes	$ 272	$ (10,491)	$ (902)	$ (11,121)

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, 2007 annual report. The total assets for the Company s operating segments have not materially changed since the December 31, 2007 annual report.

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

Overview

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

Textile Products. In 2007 and 2008, the Company derived all of its operating revenues from the textile activities of its Brookwood Companies Incorporated (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 regulation. Although the Company s textile activities have generated positive cash flow in recent years, there is no assurance that this trend will continue.

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 $28,158,000 for the 2008 first quarter were 133.9% higher than the comparable period amount of $12,036,000 in 2007.

The military had limited orders in 2006 and the 2007 first quarter for existing products and adopted revised specifications for new products to replace the products for which Brookwood s customers have been suppliers. However, the U.S. government released orders in the remaining 2007 quarters and into 2008 that include Brookwood s products, which resulted in a substantial increase in military sales. Changes in specifications or orders present a potential opportunity for additional sales; however, it is a continuing challenge to adjust to changing specifications and production requirements. Brookwood has regularly conducted research and development on various processes and products intended to comply with the revised specifications and participates in the bidding process for new military 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. The Company acknowledges the unpredictability in revenues and margins due to military sales and is unable at this time to predict future sales trends.

Unstable global nylon and chemical pricing and escalating energy costs, coupled with a varying product mix, have continued to cause fluctuations in Brookwood s margins, a trend that appears likely to continue.

Brookwood continues to identify new market niches intended to replace sales lost to imports. In addition to its existing products and proprietary technologies, Brookwood has been developing advanced breathable, waterproof laminates 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 success of Brookwood is contingent on its ability to maintain its level of military business and adapt to the global textile industry. 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. 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 arrangement, which imposed quotas through the end of 2007. The European Union and China have announced that they will jointly monitor the volume of trade in a number of highly sensitive product categories during 2008. 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; Brookwood does not believe this tax will have a material impact on its business.

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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 several Central American countries (Costa Rica, the Dominican Republic, 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 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.

Engagement of Financial Advisor. In December 2007, a special committee of the board of directors of the Company engaged a financial advisor to assist it in developing and considering the Company s strategic alternatives, including a potential sale, with respect to Brookwood. There can be no assurance that the special committee will recommend that the Company take any action with respect to Brookwood, or that any transaction will be completed.

Energy. Hallwood Energy is a privately held independent oil and gas limited partnership and operates as an upstream energy company engaging in the acquisition, development, exploration, production, and sale of hydrocarbons, with a primary focus on natural gas assets. Hallwood Energy conducts its energy activities from its corporate office located in Dallas, Texas and production offices in Searcy, Arkansas and Lafayette, Louisiana. Hallwood Energy s results of operations are and will be largely dependent on a variety of factors, including, but not limited to fluctuations in natural gas prices; success of its 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. As of March 31, 2008, the Company owned approximately 22% of the blended Class A and Class C limited partner interests (18% after consideration of profit interests) of Hallwood Energy.

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

Presentation

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

Results of Operations

The Company reported net income of $1,566,000 for the quarter ended March 31, 2008, compared to a net loss of $7,324,000 in 2007. Revenue for the 2008 first quarter was $43,987,000, compared to $28,308,000 in 2007.

Revenues

Textile products sales of $43,987,000 increased by $15,679,000, or 55.4%, in the 2008 first quarter, compared to $28,308,000, in 2007. The increase was principally due to an increase in sales of specialty fabric to U.S. military contractors as a result of increased orders from the military to Brookwood s customers. Military sales accounted for $28,158,000 and $12,036,000 in the 2008 and 2007 first quarters, which represented 64.0% and 42.5% of Brookwood s sales, respectively.

Sales to one customer, Tennier Industries, Inc. (Tennier) accounted for more than 10% of Brookwood s net sales during both the 2008 and 2007 periods. Its relationship with Tennier is ongoing. Sales to Tennier, which are included in military sales, were $14,868,000 in the 2008 first quarter, compared to $6,895,000 in 2007, which represented 33.8% and 24.4% of its net sales, respectively. Sales to another customer, ORC Industries, Inc. (ORC) accounted for more than 10% of Brookwood s sales in 2006. Its relationship with ORC is ongoing. Sales to ORC, which are also included in military sales, were $4,029,000 in the 2008 first quarter, compared to $2,206,000 in 2007, which represented 9.2% and 7.8% of its net sales, respectively.

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Expenses

Textile products cost of sales of $32,552,000 for the 2008 first quarter increased by $8,263,000, or 34.0%, compared to $24,289,000 in 2007. The 2008 increase principally resulted from material and labor costs associated with the higher sales volume and, changes in product mix and utility costs which increased 53% in the 2008 first quarter compared to the 2007 first quarter. 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 and associated manufacturer s rebates. 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 increased gross profit margin for the 2008 first quarter compared to the 2007 first quarter (26.0% versus 14.2%) principally resulted from higher sales volume, changes in product mix and manufacturing efficiencies such as reductions to material working loss.

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

	Three Months Ended March 31,	
	2008	**2007**
Textile products	$ 4,032	$ 3,521
Corporate	1,181	1,083
Total	$ 5,213	$ 4,604

Textile products administrative and selling expenses of $4,032,000 for the 2008 first quarter increased by $511,000, or 14.5%, from the 2007 amount of $3,521,000. The increase in the 2008 first quarter from the 2007 first quarter was primarily attributable to $322,000 of employee related expenses (e.g. salaries and benefits) required to support the higher sales volume and increased compliance requirements for Sarbanes-Oxley and environmental matters, $80,000 of increased factor commissions due to a higher volume of factored billings, $78,000 in research and development and $36,000 of legal and professional fees. The textile products administrative and selling expenses included items such as payroll, professional fees, sales commissions, factor 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 costs were approximately $252,000 and $174,000 in the 2008 and 2007 quarters, respectively.

Corporate administrative expenses were $1,181,000 for the 2008 first quarter, compared to $1,083,000 for 2007. The increase of $98,000, or 9.0%, was principally attributable to increased professional fees of $75,000, including costs related to the special committee s activities in developing and considering strategic alternatives with respect to Brookwood and the implementation of Sarbanes Oxley compliance requirements.

Other Income (Loss)

Equity loss from the Company s investments in Hallwood Energy, attributable to the Company s proportionate share of loss in Hallwood Energy, was $2,961,000 in the 2008 first quarter, compared to $10,503,000 in 2007. In the 2008 first quarter, Hallwood Energy reported a loss of $10,288,000, which included an expense of $4,750,000 in regards to a settlement of a lawsuit. In the 2007 first quarter, Hallwood Energy reported a loss of $41,799,000, which included an impairment of $31,680,000 associated with its oil and gas properties and an accrual of $7,100,000 as a portion of a make-whole fee in connection with a May 2008 prepayment of a loan. The make-whole fee was included in interest expense. The Company recorded the equity loss in the 2008 first quarter to the extent of the $2,961,000 loan it made to Hallwood Energy in May 2008 and reduced its carrying value of its investment in Hallwood Energy to zero. The Company s proportionate share of Hallwood Energy s accumulated losses that have not been recognized is approximately $2,587,000. The Company earned interest income of $12,000 in the 2007 first quarter from loans it made to Hallwood Energy in March 2007.

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Interest expense of $247,000 in the 2008 first quarter and $226,000 for the 2007 quarter, principally related to Brookwood s Revolving Credit Facility. The increase in interest expense was principally due to an increase in the average outstanding loan amount, partially offset by lower interest rates.

Interest and other income was $18,000 in the 2008 first quarter, compared to $181,000 in 2007. The 2008 decrease was principally due to a gain in the amount of $74,000 from the sale of a marketable security sold in March 2007 and reduced interest income earned on lower balances of cash and cash equivalents.

Income Taxes

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

	Three Months Ended March 31, 2008	2007
Federal		
Current	$	$
Deferred	807	(3,794)
Sub-total	807	(3,794)
State		
Current	659	