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HALLWOOD GROUP INC
Form 10-Q
November 15, 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 SEPTEMBER 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

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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 [X] NO []

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

| | SEPTEMBER 30, 2002 | DECEMBER 31, 2001 |
|--|-----------------------|----------------------|
| | ----- | ----- |
| | (UNAUDITED) | |
| REAL ESTATE | | |
| Investments in HRP | \$ 13,604 | \$ 12,261 |
| Receivables and other assets | | |
| Related parties | 426 | 242 |
| Other | 53 | 55 |
| | ----- | ----- |
| | 14,083 | 12,558 |
| TEXTILE PRODUCTS | | |
| Inventories | 17,657 | 16,753 |
| Receivables | | |
| Trade and other | 10,294 | 11,896 |
| Related party | 685 | 5,217 |
| Property, plant and equipment, net | 9,201 | 9,426 |
| Investment in joint venture | 1,833 | 676 |
| Prepays, deposits and other assets | 560 | 1,030 |
| | ----- | ----- |
| | 40,230 | 44,998 |
| OTHER | | |
| Deferred tax asset, net | 4,201 | 5,677 |
| Investment in HEC | 2,879 | -- |
| Cash and cash equivalents | 1,165 | 3,006 |
| Restricted cash | 978 | 966 |
| Hotel held for use - assets | 562 | 448 |
| Prepays, deposits and other assets | 476 | 408 |
| | ----- | ----- |
| | 10,261 | 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 | \$ 64,574 | \$ 77,567 |
| | ===== | ===== |

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See accompanying notes to consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS (DOLLARS IN THOUSANDS)

LIABILITIES AND STOCKHOLDERS' EQUITY

| | SEPTEMBER 30, 2002 | DECEMBER 2001 |
|---|-----------------------|------------------|
| | ----- | ----- |
| | (UNAUDITED) | |
| REAL ESTATE | | |
| Accounts payable and accrued expenses | \$ 734 | \$ |
| TEXTILE PRODUCTS | | |
| Loans payable | 14,502 | |
| Accounts payable and accrued expenses | 4,653 | |
| | ----- | ----- |
| | 19,155 | |
| OTHER | | |
| 10% Collateralized Subordinated Debentures | 6,639 | |
| Interest and other accrued expenses | 4,197 | |
| Deferred revenue - noncompetition agreement | 4,028 | |
| Term loan | 2,551 | |
| Capital lease obligations | 1,186 | |
| Hotel held for use - liabilities | 722 | |
| Convertible loan from stockholder | -- | |
| | ----- | ----- |
| | 19,323 | |
| DISCONTINUED OPERATIONS | | |
| Hotels held for sale | | |
| Accounts payable and accrued expenses | 530 | |
| Loans payable | -- | |
| | ----- | ----- |
| | 530 | |
| TOTAL LIABILITIES | 39,742 | |
| 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 | (15,736) | |
| Accumulated other comprehensive income | 206 | |
| Treasury stock, 1,034,760 shares at both dates; at cost | (15,330) | |
| | ----- | ----- |

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| | | |
|----------------------------------|-----------|-------|
| TOTAL STOCKHOLDERS' EQUITY | 23,832 | |
| | ----- | ----- |
| TOTAL | \$ 64,574 | \$ |
| | ===== | ===== |

See accompanying notes to consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

| | NINE MONTHS ENDED SEPTEMBER 30, | |
|--|------------------------------------|--------|
| | 2002 | 2001 |
| | ----- | ----- |
| REAL ESTATE | | |
| Fees | | |
| Related parties | \$ 3,838 | \$ 4,8 |
| Other | 176 | 5 |
| Equity income from investments in HRP | 1,325 | 1,7 |
| | ----- | ----- |
| | 5,339 | 7,1 |
| Administrative expenses | 1,000 | 1,6 |
| Amortization | 504 | 5 |
| Litigation expense | -- | 2,3 |
| | ----- | ----- |
| | 1,504 | 4,4 |
| | ----- | ----- |
| Income from real estate operations | 3,835 | 2,6 |
| TEXTILE PRODUCTS | | |
| Sales | | |
| Trade | 49,914 | 48,5 |
| Related party | 11,621 | 2,0 |
| Equity income from joint venture | 1,157 | 5 |
| | ----- | ----- |
| | 62,692 | 51,1 |
| Cost of sales | 52,120 | 42,6 |
| Administrative and selling expenses | 8,129 | 7,7 |
| Interest | 554 | 8 |
| | ----- | ----- |
| | 60,803 | 51,2 |
| | ----- | ----- |
| Income (loss) from textile products operations | 1,889 | (|

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| | | |
|--|---------|-------|
| OTHER | | |
| Amortization of deferred revenue - noncompetition agreement .. | 1,813 | 8 |
| Hotel revenue | 1,290 | 1,2 |
| Interest and other income | 316 | 1 |
| Equity loss from investment in HEC | (121) | |
| | ----- | ----- |
| | 3,298 | 2,2 |
| Administrative expenses | 1,390 | 1,5 |
| Hotel expenses | 1,379 | 1,3 |
| Interest expense | 637 | 1,6 |
| | ----- | ----- |
| | 3,406 | 4,5 |
| Other loss, net | (108) | (2,2) |
| | ----- | ----- |
| Income from continuing operations before income taxes | 5,616 | 3 |
| Income taxes | (1,860) | (9) |
| | ----- | ----- |
| Income (loss) from continuing operations | 3,756 | (6) |

See accompanying notes to consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

| | | |
|---|----|------------------------|
| | | NINE SE |
| | | ----- 2002 ----- |
| Income from discontinued operations, net of tax | | |
| Income (loss) from discontinued operations - Hotels | \$ | 3,7 |
| Income from discontinued operations - Energy | | |
| | | ----- |
| Income from discontinued operations | | 3,7 |
| | | ----- |
| Income before extraordinary loss and cumulative effect of changes in accounting principles | | 7,4 |
| Extraordinary loss from early extinguishment of debt | | |
| | | ----- |
| Income before cumulative effect of changes in accounting principles | | 7,4 |
| Income (loss) from cumulative effect of changes in accounting principles | | |

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| | | |
|---|----|-------|
| Income from cumulative effect of SFAS No. 142 adoption | | 5 |
| Loss from cumulative effect of SFAS No. 133 adoption | | ----- |
| Income (loss) from cumulative effect of changes in accounting principles .. | | 5 |
| | | ----- |
| NET INCOME | | 8,0 |
| Preferred stock dividend | | ----- |
| NET INCOME AVAILABLE TO COMMON STOCKHOLDERS | \$ | 7,9 |
| | | ===== |
| PER COMMON SHARE | | |
| BASIC | | |
| Income (loss) from continuing operations after preferred dividend | \$ | 2. |
| Income from discontinued operations | | 2. |
| Extraordinary loss from early extinguishment of debt | | 0. |
| Income (loss) from cumulative effect of changes in accounting principles | | ----- |
| Net income available to common stockholders | \$ | 5. |
| | | ===== |
| ASSUMING DILUTION | | |
| Income (loss) from continuing operations after preferred dividend | \$ | 2. |
| Income from discontinued operations | | 2. |
| Extraordinary loss from early extinguishment of debt | | 0. |
| Income (loss) from cumulative effect of changes in accounting principles | | ----- |
| Net income available to common stockholders | \$ | 5. |
| | | ===== |
| WEIGHTED AVERAGE SHARES OUTSTANDING | | |
| Basic | | 1,3 |
| | | ===== |
| Assuming Dilution | | 1,4 |
| | | ===== |

See accompanying notes to consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

THREE MONTHS ENDED
SEPTEMBER 30,

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| | 2002 | 2001 |
|---|----------|----------|
| REAL ESTATE | | |
| Fees | | |
| Related parties | \$ 1,460 | \$ 1,154 |
| Other | 72 | 253 |
| Equity income from investments in HRP | 378 | 534 |
| | ----- | ----- |
| | 1,910 | 1,941 |
| Administrative expenses | 433 | 480 |
| Amortization | 168 | 168 |
| Litigation expense | -- | 95 |
| | ----- | ----- |
| | 601 | 743 |
| | ----- | ----- |
| Income from real estate operations | 1,309 | 1,198 |
| TEXTILE PRODUCTS | | |
| Sales | | |
| Trade | 15,143 | 13,154 |
| Related party | 2,640 | 1,741 |
| Equity income from joint venture | 434 | 475 |
| | ----- | ----- |
| | 18,217 | 15,370 |
| Cost of sales | 14,916 | 12,720 |
| Administrative and selling expenses | 2,515 | 2,515 |
| Interest | 180 | 245 |
| | ----- | ----- |
| | 17,611 | 15,480 |
| | ----- | ----- |
| Income (loss) from textile products operations | 606 | (110) |
| OTHER | | |
| Amortization of deferred revenue - noncompetition agreement | 605 | 605 |
| Hotel revenue | 392 | 400 |
| Interest and other income | 8 | 115 |
| Equity loss from investment in HEC | (44) | -- |
| | ----- | ----- |
| | 961 | 1,120 |
| Hotel expenses | 449 | 426 |
| Administrative expenses | 416 | 722 |
| Interest expense | 207 | 351 |
| | ----- | ----- |
| | 1,072 | 1,499 |
| | ----- | ----- |
| Other loss, net | (111) | (379) |
| | ----- | ----- |
| Income from continuing operations before income taxes .. | 1,804 | 709 |
| Income taxes | (506) | (272) |
| | ----- | ----- |
| Income from continuing operations | 1,298 | 437 |

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See accompanying notes to consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

| | THREE MONTHS ENDED SEPTEMBER 30, | |
|---|-------------------------------------|-----------|
| | 2002 | 2001 |
| | ----- | ----- |
| Loss from discontinued operations, net of tax | | |
| Loss from discontinued operations - Hotels | \$ (15) | \$ (419) |
| | ----- | ----- |
| Income before extraordinary loss | 1,283 | 18 |
| Extraordinary loss from early extinguishment of debt | -- | (98) |
| | ----- | ----- |
| NET INCOME (LOSS) | 1,283 | (80) |
| Preferred stock dividend | -- | -- |
| | ----- | ----- |
| NET INCOME (LOSS) AVAILABLE TO COMMON STOCKHOLDERS | \$ 1,283 | \$ (80) |
| | ===== | ===== |
| PER COMMON SHARE | | |
| BASIC | | |
| Income from continuing operations | \$ 0.95 | \$ 0.31 |
| Income (loss) from discontinued operations | (0.01) | (0.30) |
| Extraordinary loss from early extinguishment of debt .. | -- | (0.07) |
| | ----- | ----- |
| Net income (loss) available to common stockholders .. | \$ 0.94 | \$ (0.06) |
| | ===== | ===== |
| ASSUMING DILUTION | | |
| Income from continuing operations | \$ 0.95 | \$ 0.27 |
| Income (loss) from discontinued operations | (0.01) | (0.22) |
| Extraordinary loss from early extinguishment of debt .. | -- | (0.05) |
| | ----- | ----- |
| Net income (loss) available to common stockholders .. | \$ 0.94 | \$ -- |
| | ===== | ===== |
| WEIGHTED AVERAGE SHARES OUTSTANDING | | |
| Basic | 1,361 | 1,425 |
| | ===== | ===== |

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| | | |
|-------------------------|-------|-------|
| Assuming Dilution | 1,361 | 1,973 |
| | ===== | ===== |

See accompanying notes to consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(IN THOUSANDS)
(UNAUDITED)

| | THREE MONTHS ENDED SEPTEMBER 30, | | NINE S |
|--|-------------------------------------|---------|-----------|
| | 2002 | 2001 | 200 |
| NET INCOME (LOSS) | \$ 1,283 | \$ (80) | \$ 8 |
| Other Comprehensive Income (Loss) | | | |
| Pro rata share of other comprehensive (loss) income from equity investments: | | | |
| Adoption of SFAS No. 133 | | | |
| Cumulative effect | -- | 276 | |
| Realized upon disposition of energy investment | -- | -- | |
| Change in fair value of derivatives | -- | -- | |
| Amortization of interest rate swap | (15) | (14) | |
| | ----- | ----- | ----- |
| | (15) | 262 | |
| | ----- | ----- | ----- |
| COMPREHENSIVE INCOME | \$ 1,268 | \$ 182 | \$ 7 |
| | ===== | ===== | ===== |

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)

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| | COMMON STOCK | | ADDITIONAL PAID-IN CAPITAL | ACCUMULATED DEFICIT |
|---|--------------|-----------|----------------------------------|------------------------|
| | SHARES | PAR VALUE | | |
| BALANCE, JANUARY 1, 2002 | 2,396 | \$ 240 | \$ 54,452 | \$ (23,729) |
| Net income | | | | 8,043 |
| Preferred stock dividend | | | | (50) |
| Pro rata share of stockholders' equity transactions from equity investment: Amortization of interest rate swap .. | | | | |
| BALANCE, SEPTEMBER 30, 2002 | 2,396 | \$ 240 | \$ 54,452 | \$ (15,736) |

| | TREASURY STOCK | | TOTAL STOCKHOLDERS' EQUITY |
|---|----------------|-------------|----------------------------------|
| | SHARES | COST | |
| BALANCE, JANUARY 1, 2002 | 1,035 | \$ (15,330) | \$ 15,883 |
| Net income | | | 8,043 |
| Preferred stock dividend | | | (50) |
| Pro rata share of stockholders' equity transactions from equity investment: Amortization of interest rate swap .. | | | (44) |
| BALANCE, SEPTEMBER 30, 2002 | 1,035 | \$ (15,330) | \$ 23,832 |

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)

| | NINE MONTHS SEPTEMBER |
|--|--------------------------|
| | 2002 |
| CASH FLOWS FROM OPERATING ACTIVITIES | |
| Net income | \$ 8,043 |
| Adjustments to reconcile net income to net cash provided by operating activities: | |
| Amortization of deferred revenue - noncompetition agreement | (1,813) |

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| | |
|---|----------|
| Depreciation and amortization | 1,523 |
| (Increase) decrease in deferred tax asset | 1,476 |
| Equity income from investments in HRP | (1,325) |
| Equity income from textile products joint venture | (1,157) |
| (Income) loss from cumulative effect of changes in accounting principles .. | (568) |
| Equity loss from investment in HEC | 121 |
| Amortization of deferred gain from debenture exchange | (38) |
| Extraordinary loss from early extinguishment of debt | -- |
| Net change in other assets and liabilities | (939) |
| Net change in textile products assets and liabilities | 670 |
| Discontinued operations: | |
| Extraordinary (gain) loss from extinguishment of hotel debt | (5,789) |
| Net change in other hotel assets and liabilities | 235 |
| Decrease in deferred tax asset | 1,800 |
| Gain from disposition of Hallwood Energy | -- |
| Equity income from investments in Hallwood Energy | -- |
| Increase in loss reserve for hotels | -- |
| | ----- |
| Net cash provided by operating activities | 2,239 |
| CASH FLOWS FROM INVESTING ACTIVITIES | |
| Investment in HEC common stock | (2,500) |
| Investments in textile products property and equipment | (705) |
| Investment in hotel held for use | (18) |
| Discontinued operations: | |
| Proceeds from sale of Hallwood Energy | -- |
| Proceeds from noncompetition agreement | -- |
| | ----- |
| Net cash provided by (used in) investing activities | (3,223) |
| CASH FLOWS FROM FINANCING ACTIVITIES | |
| Proceeds from bank borrowings and loans payable | 3,542 |
| Repayment of bank borrowings and loans payable | (4,263) |
| 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 | (857) |
| | ----- |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | (1,841) |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 3,006 |
| | ----- |
| CASH AND CASH EQUIVALENTS, END OF PERIOD | \$ 1,165 |
| | ===== |

See accompanying notes to consolidated financial statements.

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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 an integrated 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, breathable, 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.

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 affiliate; 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

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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

SEPTEMBER 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 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. This will result in the reclassification, required with the 2003 first quarter, of previously reported extraordinary gains (losses) from early extinguishment of debt into continuing operations.

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.

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Reclassifications. Certain reclassifications including the gross up of certain real estate revenues that were previously netted, 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 SEPTEMBER 30, 2002 | | AMOUNT AT WHICH CARRIED AT | |
|-----------------------------------|--------------------------|------------------------|----------------------------|-------------------|
| | NUMBER OF UNITS | COST OR ASCRIBED VALUE | SEPTEMBER 30, 2002 | DECEMBER 31, 2001 |
| HALLWOOD REALTY PARTNERS, L.P. .. | | | | |
| - General partner interest | -- | \$ 8,650 | \$ 1,509 | \$ 1,943 |
| - Limited partner interest | 330,432 | 8,799 | 12,095 | 10,318 |
| Totals | | \$ 17,449 | \$ 13,604 | \$ 12,261 |

At September 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 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 September 30, 2002, resulted in a \$1,736,000 decrease in the carrying value of the HRP investment. In 2001, the Company also recognized an extraordinary loss of \$108,000 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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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 over a ten-year period ending in

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October 2003. For the nine months ended September 30, 2002 and 2001 such amortization was \$504,000 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 September 30, 2002 were \$87.95 and \$36.60, 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"). An additional investment of \$1,500,000 was made in September 2002. HEC is presently in the developmental stage, having drilled four test wells. HEC is also in the process of constructing a gathering system, production facilities and commercial pipeline tap to transport any production from these wells and any future wells. Until these transportation facilities are completed, HEC is not able to determine the ultimate productivity of these wells. 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 \$44,000 and \$121,000 in the three month and nine month periods ended September 30, 2002, respectively.

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NOTE 4 -- LOANS PAYABLE

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

SEPTEMBER 30, 2002

Textile Products

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| | | | |
|--|----|--------|----|
| Revolving credit facility, prime + 0.25% or Libor + 3.25%, due January 2004 | \$ | 12,338 | \$ |
| Acquisition credit facility, prime + 1.00% or Libor + 3.25%, due January 2004 | | 1,000 | |
| Equipment term loan, 9.37% fixed, due October 2005 | | 671 | |
| Equipment term loan, Libor+ 3.25%, due March 2007 | | 493 | |
| | | ----- | |
| | | 14,502 | |
| Other | | | |
| Term loan, 7% fixed, due April 2005 | | 2,551 | |
| Revolving credit facility, prime + 0.50% or Libor + 3.25%, due April 2005 | | -- | |
| Capital lease obligations, 12.18% fixed , due December 2004 | | 1,186 | |
| Convertible loan from stockholder, 10% fixed, repaid March 2002 .. | | -- | |
| | | ----- | |
| | | 3,737 | |
| | | ----- | |
| Total | \$ | 18,239 | \$ |
| | | ===== | |

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 September 30, 2002) or Libor plus 3.25%, contains covenants, including minimum net income levels by 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 September 30, 2002, Brookwood had an additional \$1,224,000 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 September 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

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of Libor plus 3.25% (5.10% at September 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.

At September 30, 2002, Brookwood was in compliance with its loan covenants.

The outstanding balance of the combined Key Bank credit facilities at September 30, 2002 was \$14,502,000.

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 a \$1,500,000 convertible loan from stockholder in March 2002. The term loan 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 September 30, 2002 was \$2,551,000.

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.

At September 30, 2002, the Company was in compliance with its loan covenants.

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. 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, was accrued at June 30, 2002, as a reduction of gain from extinguishment of debt. The outstanding principal and interest balance at September 30, 2002 was \$1,186,000.

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

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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%.

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

| DESCRIPTION ----- | SEPTEMBER 30, 2002 ----- | DECEMBER 31 2001 ----- |
|--|--------------------------------|------------------------------|
| 10% Debentures (face amount) | \$ 6,468 | \$ 6,468 |
| Unamortized gain, net of accumulated amortization .. | 171 | 20 |
| Totals | \$ 6,639 | \$ 6,670 |

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 September 30, 2002 and December 31, 2001, respectively.

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,

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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 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 ----- | SEPTEMBER 30, 2002 ----- | DECEMBER 31, 2001 ----- |
|--|--------------------------------|-------------------------------|
| Term loan, 7.86% fixed, extinguished May 2002 | -- | \$ 6,500 |
| Term loan, 8.20% fixed, extinguished January 2002 .. | -- | 5,000 |
| Total | -- | \$ 11,500 ===== |

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 scheduled for mediation in February 2003, 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.

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

| THREE MONTHS ENDED SEPTEMBER 30, | NI |
|-------------------------------------|-------|
| ----- | ----- |
| 2002 | 2001 |
| ----- | ----- |
| 2002 | 2001 |
| ----- | ----- |

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| | | | | | |
|---|----|-------|----|-------|-------|
| Gain from extinguishment of debt | \$ | -- | \$ | 316 | \$ |
| Deferred federal income tax benefit (expense) | | -- | | 240 | (|
| Sales | | -- | | 1,123 | |
| | | | | ----- | ----- |
| | | -- | | 1,679 | |
| Expenses | | | | | |
| Operating expenses | | -- | | 1,075 | |
| Interest expense | | -- | | 294 | |
| Other disposition costs | | 15 | | -- | |
| Loss reserve | | -- | | 729 | |
| | | | | ----- | ----- |
| | | 15 | | 2,098 | |
| | | | | ----- | ----- |
| Income (loss) from discontinued hotel operations .. | \$ | (15) | \$ | (419) | \$ |
| | | ===== | | ===== | ===== |

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

| | THREE MONTHS ENDED SEPTEMBER 30, | | NINE MONTHS SEPTEMBER |
|--|-------------------------------------|-------|--------------------------|
| | 2002 | 2001 | 2002 |
| | ----- | ----- | ----- |
| Gain from disposition of investment in | | | |
| Hallwood Energy | -- | -- | -- |
| Deferred income tax benefit | -- | -- | -- |
| Current income tax (expense) | -- | -- | -- |
| Equity income from investment in Hallwood | | | |
| Energy | -- | -- | -- |
| Income from discontinued energy operations ... | -- | -- | -- |

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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"

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segment of the statement of income, was \$1,813,000 and \$605,000 in the nine months and three months ended September 30, 2002, compared to \$806,000 and \$605,000 in the 2001 periods, respectively.

NOTE 8 -- INCOME TAXES

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

| | THREE MONTHS ENDED SEPTEMBER 30, | | NINE MONTHS ENDED SEPTEMBER 30, | |
|-------------------------|-------------------------------------|----------|------------------------------------|----------|
| | 2002 | 2001 | 2002 | 2001 |
| Continuing Operations | | | | |
| Federal | | | | |
| Deferred | \$ 390 | \$ 206 | \$ 1,476 | \$ 740 |
| Current | 11 | 36 | 34 | 23 |
| Sub-total | 401 | 242 | 1,510 | 763 |
| State | 105 | 30 | 350 | 163 |
| Total | \$ 506 | \$ 272 | \$ 1,860 | \$ 926 |
| Discontinued Operations | | | | |
| Federal | | | | |
| Deferred | -- | \$ (240) | \$ 1,800 | \$ (912) |
| Current | -- | -- | -- | 400 |
| Sub-total | -- | (240) | 1,800 | (512) |
| State | -- | -- | -- | 100 |
| Total | -- | \$ (240) | \$ 1,800 | \$ (412) |

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The amount of the deferred tax asset (net of valuation allowance) was \$4,201,000 at September 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.

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.

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

| | NINE MONTHS ENDED SEPTEMBER 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 | \$ -- | \$ (4,035) |
| Realized upon disposition of energy investment | -- | 3,009 |
| Change in fair value of derivatives | -- | 1,302 |
| Amortization of interest rate swap | (44) | (14) |
| | \$ (44) | \$ 262 |
| Supplemental disclosures of cash payments: | | |
| Interest paid | \$ 1,393 | \$ 2,375 |
| Income taxes paid (refunded) | (128) | 723 |

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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 SEPTEMBER 30, | | 2001 |
|--|-------------------------------------|--------|------|
| | 2002 | 2001 | |
| INCOME (LOSS) AVAILABLE TO COMMON STOCKHOLDERS | | | |
| Income (loss) from continuing operations | \$ 1,298 | \$ 437 | \$ |
| Less dividend on preferred stock | -- | -- | |
| Impact of assumed loan conversion | -- | 87 | |
| Income (loss) from continuing operations available to common stockholders - basic | \$ 1,298 | \$ 524 | \$ |
| WEIGHTED AVERAGE SHARES OUTSTANDING | | | |
| Basic | 1,361 | 1,425 | |
| Incremental shares from assumed loan conversions | -- | 548 | |
| Assuming dilution | 1,361 | 1,973 | |

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

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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 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,

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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. 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. Oral arguments were heard in February 2002 and a rehearing en banc was held in March 2002. In August 2002, the Supreme Court affirmed the judgment of the trial court that the remaining defendants other than HRP are jointly and severally liable to HRP. The Supreme Court reversed the trial court's determination of damages, and remanded the case to the trial court to fashion appropriate relief. A hearing on the remand proceedings was held before the Court of Chancery on October 25, 2002. Since the appellate court reversed 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 in March 2002. In April 2002, the U.S. Court of Appeals for the Second Circuit upheld the lower court's ruling in favor of the defendants. In April 2002, HRP filed with the court a Petition for Rehearing en banc with respect to the April 2002 decision. In June 2002 the Second Circuit denied the petition. HRP has not sought further appellate review and the determination in favor of defendants is now final.

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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, styled Corporate Property Associates 6 & Corporate Property Associates 7 vs. The Hallwood Group Incorporated (C.A. No. 15661). The trial was held 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. In March 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 in April 2002. The parties filed their appeal and reply briefs and oral arguments were heard before the Delaware Supreme Court in September 2002. A rehearing en banc was held on November 13, 2002. The Supreme Court has not yet issued its ruling.

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 is scheduled for mediation in February 2003, 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.

Management believes that the resolution of the aforementioned litigation matters will not have a material adverse effect on the financial condition, results of operations or cash flows of the Company.

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 \$3,125,000 at September 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.

In October 2002, Brookwood entered into an agreement with its joint venture partner to acquire the remaining fifty percent interest in the joint venture. Among other things, terms include payment of \$1,000,000, to be borrowed under Brookwood's revolving credit facility, and the issuance of a two-year promissory note, payable quarterly beginning January 2003, for an amount to be mutually agreed upon by the parties. Completion of the transaction is subject to various approvals.

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NOTE 12 -- SEGMENT AND RELATED INFORMATION

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

| | REAL ESTATE | TEXTILE PRODUCTS | OTHER | DISCONTINUED OPERATIONS |
|---|----------------|---------------------|------------|----------------------------|
| | ----- | ----- | ----- | ----- |
| NINE MONTHS ENDED SEPTEMBER 30, 2002 | | | | |
| Total revenue from external sources..... | \$ 5,339 | \$ 62,692 | \$ 3,298 | |
| | ===== | ===== | ===== | |
| Operating income..... | \$ 3,835 | \$ 1,889 | | |
| | ===== | ===== | | |
| Unallocable expenses, net..... | | | \$ (108) | |
| | | | ===== | |
| Income from continuing operations before income taxes..... | | | | |
| Income from discontinued operations..... | | | | \$ 3,719 |
| | | | | ===== |
| NINE MONTHS ENDED SEPTEMBER 30, 2001 | | | | |
| Total revenue from external sources..... | \$ 7,129 | \$ 51,182 | \$ 2,285 | |
| | ===== | ===== | ===== | |
| Operating income (loss)..... | \$ 2,635 | \$ (83) | | |
| | ===== | ===== | | |
| Unallocable expenses, net..... | | | \$ (2,244) | |
| | | | ===== | |
| Income from continuing operations before income taxes..... | | | | |
| Income from discontinued operations..... | | | | \$ 10,325 |
| | | | | ===== |

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 on Form 10-K. Total assets of the Company's operating segments have not materially changed since the December 31, 2001 annual report on Form 10-K.

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

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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 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.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

Had the provisions of SFAS No. 142 been applied retroactively, the Company's net income (loss) and net income (loss) per share for the three months and nine month periods ended September 30, 2002 and 2001, respectively, would have been the pro forma amounts indicated below (in thousands, except per share amounts):

| | THREE MONTHS ENDED SEPTEMBER 30, | |
|--|-------------------------------------|---------|
| | 2002 | 2001 |
| | ----- | ----- |
| Net income (loss), as reported | \$ 1,283 | \$ (80) |
| Add back amortization: | | |
| Real estate - negative goodwill | -- | (56) |
| Textile products - positive goodwill | -- | 53 |
| Deduct cumulative effect of change in accounting principle: | | |
| Real estate - negative goodwill | -- | -- |
| | ----- | ----- |
| | -- | (3) |
| | ----- | ----- |
| Net income (loss) - pro forma | \$ 1,283 | \$ (83) |
| | ===== | ===== |
| Net income (loss) per common share - assuming dilution, as reported | \$ 0.94 | \$ -- |
| Adjustments | -- | -- |
| | ----- | ----- |
| Net income (loss) per common share - assuming dilution, pro forma | \$ 0.94 | \$ -- |
| | ===== | ===== |

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

RESULTS OF OPERATIONS

The Company reported net income of \$1,283,000 for the third quarter ended September 30, 2002, compared to a net loss of \$80,000 in 2001. Net income for the nine month periods was \$8,043,000 and \$8,759,000, respectively.

Income from continuing operations was \$1,298,000 in the quarter, compared to \$437,000 in 2001. Revenue from continuing operations for the 2002 third quarter was \$21,088,000, compared to \$18,431,000 in 2001. Income and revenue from continuing operations for the nine months in 2002 was \$3,756,000 and \$71,329,000, compared to a loss of \$618,000 and revenue of \$60,596,000 in 2001.

OVERVIEW

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. The Company has disposed of all of its hotel properties, apart from one 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 appealed the court's award of monetary damages and seeks rescission of certain transactions involving HRP's limited partner units as a remedy. The Delaware Supreme Court reversed the trial court's determination of damages, and remanded the case to the trial court to fashion appropriate relief. A hearing on the remand proceedings was held before the Court of Chancery on October 25, 2002. 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 continue 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, breathable fabrics which have been well received by its customers. Continued development of

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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. The Company invested an additional \$1.5 million in September 2002. At September 30, 2002, the Company holds an approximate 24% equity interest. At the present time this company is in the development stage, having drilled four test wells. This company is also in the process of constructing a gathering system, production facilities and commercial pipeline tap to transport any production from these wells and any future wells. Until these transportation facilities are completed, HEC is not able to determine the ultimate productivity of these wells.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

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

REAL ESTATE

The real estate segment reported income of \$1,309,000 for the third quarter and \$3,835,000 for the nine month periods of 2002, compared to income of \$1,198,000 and \$2,635,000 in 2001, respectively.

Revenues. Fee income of \$1,532,000 for the 2002 third quarter increased by \$125,000, or 9%, from \$1,407,000 in 2001. Fee income of \$4,014,000 for the nine months decreased by \$1,413,000, or 26%, from \$5,427,000 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 fluctuations were due primarily to leasing and construction supervision fees, which are cyclical in nature.

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 third quarter, the Company reported equity income of \$378,000 compared to \$534,000 in the prior-year period. For the 2002 nine months, the equity income was \$1,325,000, compared to \$1,702,000. 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 \$108,000 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

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which were reported separately.

Expenses. Administrative expenses of \$433,000 in the 2002 third quarter decreased by \$47,000, or 10%, compared to \$480,000 in 2001. For the nine months, the decrease was \$630,000 to \$1,000,000, from \$1,630,000 in 2001. The decreases were primarily attributable to the payments of commissions associated with leasing income during the 2001 periods and a reduction in tenant service costs in 2002.

Amortization expense of \$168,000 for the third quarter, and \$504,000 for the nine 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 September 30, 2002 there was \$728,000 of unamortized management rights 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 \$606,000 and \$1,889,000 for the third quarter and nine month periods of 2002, compared to a loss of \$(110,000) and \$(83,000) for the comparable periods in 2001, respectively.

Revenue. Sales of \$17,783,000 increased by \$2,888,000, or 19%, in the 2002 third quarter, compared to \$14,895,000 in the 2001 quarter. The comparative nine month sales increased by \$10,930,000, or 22%, to \$61,535,000 from \$50,605,000 in the 2001 period. Sales included \$2,034,000 and \$11,621,000 to a related party joint venture for the third quarter and nine month periods of 2002, respectively, compared to \$1,741,000 and \$2,640,000 in the comparable 2001 periods. 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. 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 \$434,000 in the 2002 third

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

quarter and \$1,157,000 for the nine month period, compared to \$475,000 and \$577,000 in the comparable 2001 periods, respectively.

Expenses. Cost of sales of \$14,916,000 increased by \$2,196,000, or 17%, in the 2002 third quarter, compared to \$12,720,000 in the 2001 third quarter. The comparative nine month cost of sales of \$52,120,000 increased by \$9,424,000, or 22%, compared to \$42,696,000 in 2001. The increases in cost of sales were primarily the result of the increase in sales. The higher gross profit margin for the 2002 third quarter (16.1% vs. 14.6%) and lower margin for the nine month periods (15.3% vs. 15.6%) resulted from differing product mixes during the

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periods.

Administrative and selling expenses of \$2,515,000 in the 2002 third quarter were unchanged from the comparable 2001 quarter. The nine month amount of \$8,129,000 increased by \$375,000, or 5%, from \$7,754,000 in the comparable 2001 period. The increase resulted primarily from an increase in indirect and administrative payroll costs.

Interest expense of \$180,000 decreased by \$65,000, or 27%, in the 2002 third quarter from \$245,000 in 2001. For the nine months, interest expense of \$554,000 decreased by \$261,000, or 32%, from \$815,000 for the comparable 2001 period. The decreases were primarily the result of lower interest rates.

OTHER

The other segment reported a loss of \$111,000 for the third quarter of 2002, compared to a loss of \$379,000 in 2001. For the nine months, the other segment reported a loss of \$108,000, compared to a loss of \$2,244,000 in 2001. The 2002 three month and nine 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 \$605,000 and \$1,813,000 in the 2002 third quarter and nine month periods, respectively, compared to \$605,000 and \$806,000 in the comparable 2001 periods, 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 beginning June 2001.

Hotel revenue, which relates entirely to the leased GuestHouse Suites Plus hotel in Huntsville, Alabama that the Company continues to operate, was \$392,000 in the 2002 third quarter and \$1,290,000 for the nine months, compared to \$400,000 and \$1,291,000 in the respective 2001 periods.

Interest and other income decreased by \$107,000 to \$8,000 for the 2002 third quarter from \$115,000 in 2001. The 2001 third quarter included increased interest income on invested funds from the sale of Hallwood Energy. The nine month amount of \$316,000 increased by \$128,000 from \$188,000 for the comparable 2001 period. The 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 \$44,000 for the 2002 third quarter and \$121,000 for the nine months relates to the Company's pro rata share of loss from HEC's operations which commenced in 2002.

Expenses. Administrative expenses of \$416,000 for the 2002 third quarter decreased by \$306,000, from the prior-year amount of \$722,000. For the nine months, administrative expenses decreased by \$151,000 to \$1,390,000 from \$1,541,000 in 2001. The decreases 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 \$23,000, or 5%, to \$449,000 in the 2002 third quarter, compared to \$426,000 in 2001. For the nine months, hotel expenses increased by \$51,000 to \$1,379,000 from \$1,328,000 in 2001. The increases are principally due to an increase in the property's repairs and maintenance expense.

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Interest expense in the amount of \$207,000 for the 2002 third quarter decreased by \$144,000 from the prior year amount of \$351,000. For the nine months, interest expense decreased by \$1,023,000 to \$637,000 from \$1,660,000 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.

INCOME TAXES

Income taxes relating to continuing operations were \$506,000 for the 2002 third quarter, compared to \$272,000 in 2001. The 2002 quarter included a \$390,000 non cash federal deferred charge, an \$11,000 federal current charge and \$105,000 for state taxes. The 2001 quarter included a \$206,000 non cash federal deferred charge, a \$36,000 federal current charge and \$30,000 for state taxes. Income taxes were \$1,860,000 for the 2002 nine month period, compared to \$926,000 in 2001. The nine months in 2002 included a deferred tax charge of \$476,000, a current tax charge of \$34,000 and state tax expense of \$350,000. The 2001 nine month amount included a deferred tax charge of \$740,000, a federal current charge of \$23,000 and state tax expense of \$163,000. 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 September 30, 2002, the Company had approximately \$90,000,000 of combined 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 \$12,350,000 of the NOLs prior to their ultimate expiration in the year 2020.

Management believes that the Company has certain tax planning strategies 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.

DISCONTINUED OPERATIONS - HOTELS

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

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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 nine months ended September 30, 2002 and 2001 are presented below (in thousands):

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

| | THREE MONTHS ENDED SEPTEMBER 30, | | |
|--|-------------------------------------|----------|-------|
| | 2002 | 2001 | |
| Gain from extinguishment of debt | \$ -- | \$ 316 | \$ |
| Deferred federal income tax benefit (expense) | -- | 240 | |
| Sales | -- | 1,123 | |
| | | ----- | |
| | | 1,679 | |
| Expenses | | | |
| Operating expenses | -- | 1,075 | |
| Interest expense | -- | 294 | |
| Other disposition costs | 15 | -- | |
| Loss reserve (recovery) | -- | 729 | |
| | | ----- | |
| | 15 | 2,098 | |
| | | ----- | |
| Income (loss) from discontinued hotels operations .. | \$ (15) | \$ (419) | \$ |
| | ===== | ===== | ===== |

As of June 2002, the Company completed the disposition of the four hotel properties it had classified as discontinued operations; however, it is currently a defendant in two lawsuits in connection with the disposition of the hotels.

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

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\$282,000 in the 2002 nine month period decreased by \$6,784,000, from the year-ago amount of \$7,066,000. The decrease was 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; the Tulsa GuestHouse Suites hotel in January 2002; and the Greenville GuestHouse Suites hotel in June 2002.

Expenses. Operating expenses of \$325,000 for the 2002 nine months decreased by \$5,789,000 from \$6,114,000 in 2001. The decrease is primarily due to the aforementioned dispositions. Interest expense of \$183,000 in the 2002 nine month period decreased by \$1,359,000 from \$1,542,000 in 2001, 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 \$44,000 for the 2002 nine month period 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.

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 nine months ended September 30, 2001 are presented below (in thousands):

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

| | THREE MONTHS ENDED SEPTEMBER 30, | | |
|---|-------------------------------------|------|---|
| | 2002 | 2001 | 2 |
| Gain from disposition of investment in Hallwood Energy .. | -- | -- | |
| Deferred income tax benefit | -- | -- | |
| Current income tax (expense) | -- | -- | |
| Equity income from investment in Hallwood Energy | -- | -- | |
| | | | |
| Income from discontinued energy operations | -- | -- | |

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.

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The equity income in the 2001 nine month periods from investment in Hallwood Energy of \$1,837,000, 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.

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 expire 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.

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

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| | THREE MONTHS ENDED SEPTEMBER 30, | | NINE MONTHS ENDED SEPTEMBER 30, | |
|----------------------------------|-------------------------------------|----------|------------------------------------|----------|
| | 2002 | 2001 | 2002 | 2001 |
| Property management fees | \$ 522 | \$ 484 | \$ 1,516 | \$ 1,521 |
| Leasing fees | 714 | 169 | 1,404 | 1,883 |
| Asset management fees | 155 | 153 | 464 | 461 |
| Construction supervision fees .. | 69 | 348 | 454 | 910 |
| Acquisition fees | -- | -- | -- | 120 |
| Total | \$ 1,460 | \$ 1,154 | \$ 3,838 | \$ 4,895 |

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. Additionally, the Company reimburses HSC for reasonable and necessary expenses in providing office space and administrative services. A summary of the fees and expenses paid to HSC are detailed below (in thousands):

| | THREE MONTHS ENDED SEPTEMBER 30, | | NINE MONTHS ENDED SEPTEMBER 30, | |
|---------------------------------------|-------------------------------------|--------|------------------------------------|-------|
| | 2002 | 2001 | 2002 | 2001 |
| Consulting fees | \$ 198 | \$ 198 | \$ 596 | \$ 48 |
| Office and administrative expenses .. | 27 | 22 | 68 | 6 |
| Total | \$ 225 | \$ 242 | \$ 664 | \$ 54 |

Hallwood Investments Limited. During 2000 and 2001, the Company entered into loan agreements totaling \$4,000,000 with Hallwood Investments Limited, an entity with which Mr. Gumbiner is associated. Several factors contributed to the Company's cash flow needs at the time, including difficulties experienced by the Company's hotel operations and restriction on the availability of distributions and payments from Brookwood. The loans bore an interest rate of 10% and were repaid in December 2001 and March 2002.

Hallwood Energy Corporation. In January 2002, the Company invested \$1,500,000 in a newly-formed private energy company - Hallwood Energy Corporation ("HEC"). An additional investment of \$1,500,000 was made in September 2002. The Company owns approximately 24% of HEC and accounts for the investment using the equity method of accounting. Certain of the Company's current officers and directors and certain officers and directors of its former Hallwood Energy affiliate are investors in the new privately-held entity.

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Brookwood. In 2000, Brookwood formed a joint venture with an unrelated third party that is also in a textile related industry. Brookwood is a 50% joint venture partner. The joint venture has been developing advanced lightweight, water resistant, breathable fabrics. Brookwood reported sales to the joint venture of \$2,640,000 and \$11,621,000 for the three month and nine month periods ended September 30, 2002, respectively, compared to \$1,741,000 and \$2,034,000 in the comparable 2001 periods.

CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS

The Company and its Brookwood subsidiary have entered into various obligations and commitments in the ordinary course of conducting its business operations, which are provided below as of September 30, 2002 (in thousands):

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| | | PAYMENTS DUE BY SEPTEMBER 30, | | | |
|--------------------------------|----|-------------------------------|-----------|----------|------------|
| | | 2003 | 2005 | 2007 | THEREAFTER |
| OBLIGATIONS | | | | | |
| Long term debt | | | | | |
| Term Loan and Revolving | | | | | |
| Credit Facility | \$ | 965 | \$ 1,586 | \$ -- | \$ -- |
| 10% Debentures | | -- | 6,468 | -- | -- |
| Loans payable (Brookwood) .. | | 295 | 13,995 | 212 | -- |
| Capital lease obligations | | 515 | 671 | -- | -- |
| Operating leases | | 1,065 | 1,892 | 1,124 | 1,749 |
| | | ----- | ----- | ----- | ----- |
| Total | \$ | 2,840 | \$ 24,612 | \$ 1,336 | \$ 1,749 |
| | | ===== | ===== | ===== | ===== |

| | | AMOUNT OF COMMITMENT EXPIRATION BY SEPTEMBER 30, | | | | |
|--------------------------------|----|--|--------|-------|------------|-------|
| | | 2003 | 2005 | 2007 | THEREAFTER | TOTAL |
| COMMITMENTS (Brookwood) | | | | | | |
| Letters of Credit | \$ | 109 | \$ -- | -- | -- | \$ |
| Employment contracts ... | | 279 | 250 | -- | -- | |
| | | ----- | ----- | ----- | ----- | ----- |
| Total | \$ | 388 | \$ 350 | -- | -- | \$ |
| | | ===== | ===== | ===== | ===== | ===== |

The Company's new Term Loan and Revolving Credit Facility acquired in

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March 2002, and 10% Debentures require compliance with various loan covenants and financial ratios, which, if not met, will trigger a default. The Term Loan and Revolving Credit Facility requires a minimum debt service coverage ratio, as defined, for each rolling four quarter period, a senior leverage ratio, as defined, and a minimum collateral value coverage. Additionally, Brookwood's credit agreement requires compliance with various loan covenants and financial ratios, principally a minimum net income and debt service coverage ratio and a debt to equity ratio.

The principal ratios at September 30, 2002 are provided below (dollar amounts in thousands):

| DESCRIPTION ----- | REQUIRED AMOUNT ----- | ACTUAL ----- |
|--|----------------------------------|-----------------|
| TERM LOAN AND REVOLVING CREDIT FACILITY | | |
| Net cash flow, as defined | must exceed \$3,400 | \$4,383 |
| Debt service coverage | must exceed 1.2 to 1.0 | 1.54 |
| Senior leverage | must be less than 2.5 to 1.0 | 1.22 |
| Collateral value coverage | must exceed 200% of loan balance | 1,035% |
| BROOKWOOD CREDIT AGREEMENT | | |
| Minimum net income, as defined | must exceed \$1,100 ytd 9/30/02 | \$1,134 |
| Debt service coverage | must exceed 1.25 to 1.00 | 1.43 |
| Debt to equity | must be less than 45% | 43% |

The Indenture for the 10% Debentures contains various covenants, which if violated, may result in a call of the entire issue. The principal covenants prohibit any subsidiary of the Company from commencing receivership, bankruptcy or insolvency proceedings.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

LIQUIDITY AND CAPITAL RESOURCES

The Company's unrestricted cash and cash equivalents at September 30, 2002 totaled \$1,165,000.

In March 2002, the Company and its HWG, LLC subsidiary entered into the \$7,000,000 Term Loan and Revolving Credit Facility 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 proceeds were used in part to repay the \$1,500,000 convertible loan from stockholder in March 2002 and requires a monthly payment of \$92,631. The revolving credit facility bears interest at the Company's option of one-half percent over prime, 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. The credit agreement contains various financial and non-financial covenants, including the maintenance of financial ratios, restrictions on new indebtedness and the payment of dividends. At September 30, 2002, the Company was in compliance with its loan covenants.

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The Company has not drawn any funds on the revolving credit facility, and therefore has \$4,000,000 of unused borrowing capacity.

The Company's real estate segment generates funds principally from its property management and leasing activities, without significant additional capital costs. The Company has pledged 300,397 of its HRP limited partnership units and the interest in its real estate subsidiaries to collateralize the Term Loan and Revolving Credit Facility and the remaining 30,035 HRP units to secure all of the capital leases.

Brookwood maintains a revolving line of credit facility which is collateralized by accounts receivable, certain inventory and equipment, and separate acquisition and equipment credit facilities. At September 30, 2002, Brookwood had an additional \$1,224,000 of borrowing base availability under its revolving line of credit facility. Future cash dividends and tax sharing payments to the parent company are contingent upon Brookwood's compliance with the covenants contained in the amended loan agreement. At September 30, 2002, Brookwood was in compliance with its loan covenants.

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. In the fourth quarter of 2001, in consideration of thirty six monthly payments aggregating approximately \$375,000, the contingent obligation had been reduced to a percentage of cash flow from the acquired subsidiaries, as defined, and recorded as a charge to operations the amount for the remaining years under the agreement.

In October 2002, Brookwood entered into an agreement with its joint venture partner to acquire the remaining fifty percent interest in the joint venture. Among other things, terms include payment of \$1,000,000, to be borrowed under Brookwood's revolving credit facility, and the issuance of a two-year promissory note, payable quarterly beginning January 2003, for an amount to be mutually agreed upon by the parties. Completion of the transaction is subject to various approvals.

The Company's hotel segment experienced cash flow difficulties during 2000, due to weaker occupancy and average daily rates at several hotels. 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. At September 30, 2002, the Company continues to operate one hotel, which has been classified as hotel held for use. The Company did not receive any proceeds from completion of foreclosure or sale of hotel properties and all non-recourse debt has been extinguished. Payments on the three capital leases continue to be made by the Company or its one operating hotel subsidiary.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

FORWARD-LOOKING STATEMENTS

In the interest of providing stockholders with certain information

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regarding the Company's future plans and operations, certain statements set forth in this Form 10-Q are forward-looking statements. Although any forward-looking statement expressed by or on behalf of the Company is, to the knowledge and in the judgment of the officers and directors, expected to prove true and come to pass, management is not able to predict the future with absolute certainty. Forward-looking statements involve known and unknown risks and uncertainties, which may cause the Company's actual performance and financial results in future periods to differ materially from any projection, estimate or forecasted result. Among others, these risks and uncertainties include, the ability to obtain financing or refinance maturing debt; a potential oversupply of commercial office buildings and industrial parks in the markets served; fees for leasing, construction and acquisition of real estate properties; lease and rental rates and occupancy levels obtained; and the ability to compete successfully with foreign textile production and the ability to generate new products. These risks and uncertainties are difficult or impossible to predict accurately and many are beyond the control of the Company. Other risks and uncertainties may be described, from time to time, in the Company's periodic reports and filings with the Securities and Exchange Commission.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABUT MARKET RISK

There have been no material changes to the Company's market risks during the nine months ended September 30, 2002.

The Company is exposed to market risk due to fluctuations in interest rates. The Company utilizes both fixed rate and variable rate debt to finance its operations. As of September 30, 2002, the Company's total outstanding loans and debentures payable of \$24,707,000 were comprised of \$11,369,000 of fixed rate debt and \$12,338,000 of variable rate debt. There is inherent rollover risk for borrowings as they mature and are renewed at current market rates. The extent of this risk is not quantifiable or predictable because of the variability of future interest rates and the Company's future financing requirements. A hypothetical increase in interest rates of one percentage point would cause an annual loss in income and cash flows of approximately \$247,000, assuming that outstanding debt remained at current levels.

The Company's real estate division through its investment in HRP will sometimes use derivative financial instruments to achieve a desired mix of fixed versus floating rate debt. As of September 30, 2002, HRP had an interest cap agreement for one of its mortgage loans, which will limit HRP's exposure to changing interest rates to a maximum of 10%. Management does not consider the portion attributable to the Company to be significant.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures. It is the conclusion of the registrant's principal executive officer and principal financial officer that the registrant's disclosure controls (as defined in Exchange Act rules 13a-14 and 15d-14), based on their evaluation of these controls and procedures as of a date within 90 days of the filing of this quarterly report, are effective.

Changes in internal controls. There were no significant changes in the registrant's internal controls or in other factors that could significantly

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affect these controls subsequent to the date of their evaluation.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

PART II - OTHER INFORMATION

Item

1 Legal Proceedings

Reference is made to Note 11 to the Company's consolidated financial statements included within this Form 10-Q.

2 Changes in Securities

None

3 Defaults upon Senior Securities

None

4 Submission of Matters to a Vote of Security Holders

None

5 Other Information

None

6 Exhibits and Reports on Form 8-K

(a) Exhibits

None

(b) Reports on Form 8-K

(i) Dated August 14, 2002 -- Certification of principal executive officer and principal financial officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, in connection with the filing of Form 10-Q for the quarter ended June 30, 2002

(ii) Dated September 3, 2002 -- Disclosure of Supreme Court of Delaware decision in Gotham Partners, L.P. vs. Hallwood Realty Partners, L.P., et al (c.a. no. 15754)

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

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THE HALLWOOD GROUP INCORPORATED

Dated: November 14, 2002

By: /s/ Melvin J. Melle

Melvin J. Melle, Vice President
(Duly Authorized Officer and
Principal Financial and
Accounting Officer)

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OFFICER CERTIFICATION

I, Anthony J. Gumbiner, certify that:

1. I have reviewed this quarterly report on Form 10-Q of The Hallwood Group Incorporated (the "Registrant");
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report;
4. The Registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the Registrant and we have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities particularly during the period in which this quarterly report is being prepared;
 - b) evaluated the effectiveness of the Registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The Registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the Registrant's auditors and the audit committee of Registrant's board of directors (or persons performing the equivalent function):
 - a) all significant deficiencies in the design or operation of

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internal controls which could adversely affect the Registrant's ability to record, process, summarize and report financial data and have identified for the Registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal controls; and

6. The Registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 14, 2002

/s/ Anthony J. Gumbiner

By: Anthony J. Gumbiner
Title: Chief Executive Officer

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OFFICER CERTIFICATION

I, Melvin J. Melle, certify that:

1. I have reviewed this quarterly report on Form 10-Q of The Hallwood Group Incorporated (the "Registrant");
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report;
4. The Registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the Registrant and we have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities particularly during the period in which this quarterly report is being prepared;
 - b) evaluated the effectiveness of the Registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

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- c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The Registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the Registrant's auditors and the audit committee of Registrant's board of directors (or persons performing the equivalent function):
- a) all significant deficiencies in the design or operation of internal controls which could adversely affect the Registrant's ability to record, process, summarize and report financial data and have identified for the Registrant's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal controls; and
6. The Registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 14, 2002

/s/ Melvin J. Melle

By: Melvin J. Melle
Title: Chief Financial Officer