

**FINANCIAL HIGHLIGHTS**  
(in thousands, except per share amounts)

	Years ended December 31,		
	2006	2005	2004
Revenue . . . . .	\$112,154	\$134,607	\$137,280
Income (loss) from continuing operations . . . . .	(6,725)	26,342	54,700
Income from discontinued operations . . . . .	—	—	39,785
Net income (loss) . . . . .	(6,725)	26,342	94,485
Net income (loss) per share (assuming dilution) . . . . .	(4.44)	17.47	63.55
Total assets . . . . .	107,597	108,801	157,317
Total debt . . . . .	11,892	7,812	10,136
Stockholders' equity . . . . .	81,966	88,443	124,541
Cash dividends on common shares . . . . .	—	66,119	—
Cash dividend per common share . . . . .	—	43.87	—

**BUSINESS SEGMENTS**

The Hallwood Group Incorporated (the "Company") (AMEX:HWG) is a holding company that has a 100% consolidated investment in its textile products subsidiary, Brookwood Companies Incorporated, and a 25% equity investment in its energy affiliate, Hallwood Energy, L.P.

Brookwood again enjoyed a profitable year and posted revenues of \$112.2 million in 2006, compared to \$133.1 million in 2005 and \$136.3 million in 2004. Its operating income before interest and taxes was \$5.6 million in 2006, compared to \$11.7 million in 2005 and \$18.5 million in 2004.

Hallwood Energy reported a net loss of \$41.4 million in 2006, principally from an impairment of its oil and gas properties in the amount of \$28.4 million. The Company recognized \$10.4 million as its proportionate share of such loss using the equity method of accounting.

## CASH DIVIDENDS AND ASSET DISPOSITIONS

### *Cash Dividends*

In April 2005, the Company announced a cash dividend in partial liquidation to stockholders. The dividend in the amount of \$37.70 per share, totaling approximately \$56.8 million, was paid in May 2005. The dividend was in partial liquidation of the Company, as a result of the Company's disposition of its real estate interests and partnership units relating to Hallwood Realty Partners, L.P. in July 2004, and the board of directors' determination to discontinue the Company's real estate activities effective January 1, 2005.

In connection with the plan of partial liquidation, the board of directors determined to review the cash position of the Company at any time through December 31, 2005, and consider declaring an additional liquidating dividend not to exceed (together with the May dividend) the approximate amount received in the disposition. In July 2005, the Company announced an additional cash dividend in partial liquidation to stockholders. This dividend, in the amount of \$6.17 per share, totaling approximately \$9.3 million, was paid in August 2005.

### *Asset Dispositions*

In July 2006, Hallwood Energy sold a 60% working interest in its West Texas properties and 100% of its properties in North Central Texas to Chesapeake Energy Company.

In July 2005, the Company disposed of its general and limited partner investments in its former Hallwood Energy III, L.P. affiliate for approximately \$56 million. Results of operations through the date of sale were included in continuing operations.

In December 2004, the Company disposed of its common stock investment in its former Hallwood Energy Corporation affiliate for approximately \$56 million. Results of operations through the date of sale were included in continuing operations.

In July 2004, the Company disposed of its general and limited partner investments in its former Hallwood Realty Partners, L. P. affiliate and related assets for approximately \$66 million. Results of operations through the date of sale were included in discontinued operations.

## TO OUR STOCKHOLDERS

We are pleased to present the Company's 2006 Annual Report, which includes results for the years ended December 31, 2006, 2005 and 2004.

### Continuing Operations

For the 2006 year, the loss from continuing operations was \$6.7 million, or \$4.44 per share (assuming dilution), compared to income of \$26.3 million, or \$17.47 per share in 2005, and income of \$54.7 million, or \$36.79 per share in 2004, on revenue of \$112.1 million, \$134.7 million and \$137.3 million, respectively.

### *Textile Products*

The Company's Brookwood subsidiary is an integrated textile company focused on woven nylon products. Converting, design, marketing and administrative operations are conducted at its New York City offices. Through its Rhode Island dyeing and finishing plant and laminating plant in Connecticut, Brookwood develops and produces innovative woven fabrics and related products through specialized finishing, treating and coating processes.

Brookwood is a market leader in its industry and is seeking to expand its high tech textile businesses to drive sales and profits. It produces laminated fabrics using its own branded breathable film, including "Storm-Tech®," "Assault®," "Barrier Assault Textile Technology™" and "X-202 U.S.A.™". In addition, Brookwood markets other consumer branded fibers and fabrics such as "Cordura®" and "Supplex®".

### *Energy*

In April 2007, the Company invested an additional \$6.7 million as part of an overall financing plan that included a new Hallwood Energy loan facility from one of its investors in the amount of \$100.0 million.

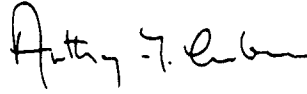
As of December 31, 2006, the Company had \$50.4 million invested in its Hallwood Energy affiliate, before the recognition of its proportionate share of Hallwood Energy's losses using the equity method of accounting that reduced the carrying value to \$39.9 million. Hallwood Energy's losses in 2006 included an impairment of its reserves in the amount of \$28.4 million.

In 2004, the Company recorded a gain from sale of its minority investment in Hallwood Energy Corporation in the amount of \$62.3 million and, in 2005, the Company recorded a gain from sale of its minority investments in Hallwood Energy III, L.P. in the amount of \$52.4 million.

### **Acknowledgments**

Once again I wish to thank our employees for their continued efforts, and our stockholders and bank lenders for their continued support.

Sincerely,

A handwritten signature in black ink, appearing to read "Anthony J. Gumbiner". The signature is written in a cursive style with a large initial 'A'.

Anthony J. Gumbiner  
Chairman and Chief Executive Officer

May 18, 2007