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PETROCORP INC  
Form 10-Q  
August 13, 2002

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly period ended June 30, 2002  
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OR

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

For the Transition period \_\_\_\_\_ to \_\_\_\_\_  
-----

Commission File Number 0-22650  
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PETROCORP INCORPORATED  
(Exact name of registrant as specified in its charter)

Texas  
(State or Other Jurisdiction of  
Incorporation or Organization)

76-0380430  
(I.R.S. Employer  
Identification No.)

6733 South Yale  
Tulsa, Oklahoma  
(Address of Principal Executive Offices)

74136  
(Zip Code)

Registrant's Telephone Number, Including Area Code: (918) 491-4500

Not Applicable  
-----

(Former Name, Former Address and Former Fiscal Year,  
if changed since last report)

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 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  
-----        -----

Indicate the number of shares outstanding of each of the Registrant's classes of  
stock, as of July 31, 2002:

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Common Stock, \$.01 per value ----- (Title of Class)	12,545,109 ----- (Number of Shares Outstanding)
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PETROCORP INCORPORATED

INDEX

	PAGE NO. -----
PART I. FINANCIAL INFORMATION	
Item 1. Financial Statements	
Consolidated Balance Sheets at June 30, 2002 and December 31, 2001	1
Consolidated Statements of Operations for the three and six months ended June 30, 2002 and 2001	2
Consolidated Statements of Cash Flows for the six months ended June 30, 2002 and 2001	3
Notes to Consolidated Financial Statements	4
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	10
Item 3. Quantitative and Qualitative Disclosures about Market Risk	14
PART II. OTHER INFORMATION	15
SIGNATURES	16

Certain matters discussed in this report, excluding historical information, include forward-looking statements - statements that discuss the Company's expected future results based on current and pending business operations. The Company is making these forward-looking statements in reliance on the safe harbor protections provided under the PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995.

Forward-looking statements can be identified by words such as "anticipates," "believes," "expects," "planned," "scheduled" or similar expressions. Although the Company believes these forward-looking statements are based on reasonable assumptions, statements made regarding future results are subject to numerous assumptions, uncertainties and risks that may cause future results to be materially different from the results stated or implied in this document. Important risk factors (but not necessarily all important factors) that could cause actual results to differ materially from those expressed in any forward-looking statement made by, or on behalf of, the Company would include, but in no way be limited by, the Company's ability to obtain agreements with co-venturers, partners and governments; its ability to engage drilling,

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construction and other contractors; its ability to obtain economical and timely financing; geological, land, sea or weather conditions; world prices for oil, natural gas and natural gas liquids; adequate and reliable transportation systems; and foreign and United States laws, including tax laws. Additional information about issues that could lead to material changes in performance is contained in the Company's Form 10-K.

### PART I. FINANCIAL INFORMATION

#### ITEM 1. Financial Statements

PETROCORP INCORPORATED  
CONSOLIDATED BALANCE SHEETS  
(in thousands, except share amounts)  
(Unaudited)

	June 30, 2002
Assets	-----
Current assets:	
Cash and cash equivalents	\$ 3,593
Accounts receivable, net	16,850
Other current assets	1,518
	-----
Total current assets	21,961
	-----
Property, plant and equipment:	
Oil and gas properties, at cost, full cost method, net of accumulated depreciation, depletion, amortization and impairment	120,619
Other, net	912
	-----
	121,531
	-----
Deferred income taxes	22,048
Other assets, net	2,701
	-----
Total assets	\$ 168,241
	=====
Liabilities and Shareholders' Equity	
Current liabilities:	
Accounts payable	\$ 9,269
Accrued liabilities	3,232
Current portion of long-term debt	1,288
	-----
Total current liabilities	13,789
	-----
Long-term debt	42,365
	-----
Deferred income taxes	14,716
	-----
Shareholders' equity:	

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Preferred stock, \$0.01 par value, 1,000,000 shares authorized, none issued	
Common stock, \$0.01 par value, 25,000,000 shares authorized, 12,585,109 and 12,556,109 shares outstanding as of June 30, 2002 and December 31, 2001, respectively	129
Additional paid-in capital	111,395
Accumulated deficit	(6,240)
Accumulated other comprehensive loss (NOTE 2)	(5,563)
Treasury stock, at cost (264,607 shares)	(2,350)
	-----
Total shareholders' equity	97,371
	-----
Total liabilities and shareholders' equity	\$ 168,241
	=====

The accompanying notes are an integral part of these financial statements.

1

PETROCORP INCORPORATED  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(in thousands, except share amounts)  
(Unaudited)

	For the three months ended June 30,		For the six months ended June 30,	
	2002	2001	2002	2001
	-----	-----	-----	-----
Revenues:				
Oil and gas	\$ 11,976	\$ 11,655	\$ 22,661	\$
Plant processing	567	480	1,056	
Other	351	621	651	
	-----	-----	-----	-----
	12,894	12,756	24,368	
	-----	-----	-----	-----
Expenses:				
Production costs	3,431	2,901	7,233	
Depreciation, depletion and amortization	4,381	2,941	8,867	
General and administrative	671	511	1,357	
Other operating expenses	368	665	689	
	-----	-----	-----	-----
	8,851	7,018	18,146	
	-----	-----	-----	-----
Income from operations	4,043	5,738	6,222	
	-----	-----	-----	-----
Other income (expenses):				
Investment income	61	56	91	
Interest expense	(626)	(449)	(1,355)	
Other income (expenses)	291	(1,053)	454	
	-----	-----	-----	-----
	(274)	(1,446)	(810)	

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Income before income taxes	3,769	4,292	5,412
Income tax provision:			
Current	585	1,453	1,027
Deferred	804	240	959
	1,389	1,693	1,986
Net income	\$ 2,380	\$ 2,599	\$ 3,426
Net income per common share - basic:	\$ 0.19	\$ 0.27	\$ 0.27
Net income per common share - diluted:	\$ 0.19	\$ 0.26	\$ 0.27
Weighted average number of common shares - basic	12,561	9,783	12,559
Weighted average number of common shares - diluted	12,685	9,966	12,680

The accompanying notes are an integral part of these financial statements.

2

PETROCORP INCORPORATED  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(in thousands)  
(Unaudited)

	For the six mo ended June 3
	2002
Cash flows from operating activities:	
Net income	\$ 3,426
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation, depletion and amortization	8,867
Deferred income tax expense	959
Other	64
Changes in operating assets and liabilities:	
Accounts receivable	(3,583)
Other current assets	(406)
Accounts payable	2,561
Accrued liabilities	259
Income tax payable	-
Net cash provided by operating activities	12,147
Cash flows from investing activities:	
Additions to oil and gas properties	(4,132)
Additions to plant and related facilities	(206)
Purchase of Southern Mineral Corporation net assets	-

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Net cash used in investing activities	(4,338)
Cash flows from financing activities:	
Proceeds from long-term debt	3,465
Repayment of long-term debt	(9,106)
Other	218
Net cash used in financing activities	(5,423)
Effect of exchange rate changes on cash	(58)
Net increase (decrease) in cash and cash equivalents	2,328
Cash and cash equivalents at beginning of period	1,265
Cash and cash equivalents at end of period	\$ 3,593

The accompanying notes are an integral part of these financial statements.

3

PETROCORP INCORPORATED  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

NOTE 1 - BASIS OF PRESENTATION

The unaudited consolidated financial statements of PetroCorp Incorporated (the "Company" or "PetroCorp") have been prepared in accordance with generally accepted accounting principles for interim financial information and with instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal and recurring adjustments necessary for a fair presentation, have been included. For further information, refer to the consolidated financial statements and footnotes thereto for the year ended December 31, 2001, included in the Company's 2001 Annual Report on Form 10-K/A pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (10-K). Interim period results are not necessarily indicative of results of operations or cash flows for a full-year period.

NOTE 2 - COMPREHENSIVE INCOME

The Company follows SFAS No. 130, "Reporting Comprehensive Income." This Statement establishes requirements for reporting comprehensive income and its components which includes the Company's foreign currency translation adjustment and derivative cash flow hedges. The Company's comprehensive income for the three and six months ended June 30, 2002 and 2001 is as follows (in thousands):

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	For the three months ended June 30,		For the six months ended June 30,	
	2002	2001	2002	2001
Net income .....	\$ 2,380	\$ 2,599	\$ 3,426	\$ 8,805
Derivative hedging gain (loss) (net of taxes of (\$83) and \$290) .....	153	390	(445)	390
Reclassification of hedging gain (loss) to income (net of taxes of \$68 and \$180) .....	115	-	283	-
Foreign currency translation gain (loss) ...	1,993	1,779	1,910	49
	\$ 2,261	\$ 2,169	\$ 1,748	\$ 439
Comprehensive income (loss) .....	\$ 4,641	\$ 4,768	\$ 5,174	\$ 9,244

As of June 30, 2002, accumulated other comprehensive loss consisted of \$730 of derivative gain, net of taxes, and \$6,293 of foreign currency translation losses.

4

NOTE 3 - EARNINGS PER SHARE

The following is a reconciliation of the numerators and denominators of the basic and diluted per share computations for the periods presented (in thousands, except share amounts):

	Net Income	Shares	Per Share Amount
Three months ended June 30,			
2002			
Basic EPS:			
Net income .....	\$ 2,380	12,561	\$ 0.19
Effect of dilutive securities:			
Options .....	-	124	-
Diluted EPS:			
Net income .....	\$ 2,380	12,685	\$ 0.19
2001			
Basic EPS:			
Net income .....	\$ 2,599	9,783	\$ 0.27
Effect of dilutive securities:			
Options .....	-	183	(0.01)
Diluted EPS:			

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Net income .....	\$ 2,599	9,966	\$ 0.26
	=====	=====	=====
Six months ended June 30, 2002			
Basic EPS:			
Net income .....	\$ 3,426	12,559	\$ 0.27
Effect of dilutive securities:			
Options .....	-	121	-
	-----	-----	-----
Diluted EPS:			
Net income .....	\$ 3,426	12,680	\$ 0.27
	=====	=====	=====
2001			
Basic EPS:			
Net income .....	\$ 8,805	9,253	\$ 0.95
Effect of dilutive securities:			
Options .....	-	174	(0.02)
	-----	-----	-----
Diluted EPS:			
Net loss .....	\$ 8,805	9,427	\$ 0.93
	=====	=====	=====

The net income per share amounts do not include the effect of potentially dilutive securities of 405,610 and 176,117 for the three months ended June 30, 2002 and 2001, respectively, and 405,610 and 540,117 for the six months ended June 30, 2002 and 2001, respectively, as the impact of these outstanding options was antidilutive.

5

NOTE 4 - MERGER WITH SOUTHERN MINERAL CORPORATION

PetroCorp completed the acquisition of Southern Mineral Corporation ("Southern Mineral") on June 6, 2001. The acquisition of Southern Mineral was accounted for using the purchase method of accounting as of June 1, 2001 because as of that date, the company had effective control, and the results of operations have been included since that date.

The following unaudited pro forma information has been prepared assuming Southern Mineral had been acquired as of the beginning of the period presented. The pro forma information is presented for information purposes only and is not necessarily indicative of what would have occurred if the acquisition had been made as of that date. In addition, the pro forma information is not intended to be a projection of future results and does not reflect any efficiencies that may result from the integration of Southern Mineral.

Pro Forma Information (Unaudited)  
(In thousands, except per share data)

	Six Months Ended June 30, 2001
	-----
Revenues .....	\$ 40,738
Income before income taxes .....	\$ 15,780



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Net income .....	\$ 9,395
Earnings per common share - basic .....	\$ 0.75
Earnings per common share - diluted .....	\$ 0.74

The above pro forma data reflects \$3,665 of bankruptcy expenses and restructuring costs (primarily investment banker and employee severance related costs) for Southern Mineral for the six months ended June 30, 2001. Based on evaluations in connection with tax returns to be filed in 2002, the Company adjusted prior estimates of the deferred taxes attributable to the assets acquired. Accordingly, proved oil and gas properties were reduced by \$4.5 million and Deferred tax assets increased by the same amount.

### NOTE 5 - HEDGING ACTIVITIES

To reduce the impact of fluctuations in the market prices of oil and natural gas, the Company periodically utilizes hedging strategies such as futures transactions or swaps to hedge the price of a portion of its future oil and natural gas production. Results of these hedging transactions are reflected in oil and natural gas sales in the month of the hedged production.

As part of PetroCorp's acquisition of Southern Mineral, the Company obtained crude oil and natural gas costless collars with a fair value (liability) at the date of acquisition of \$821,000. The estimated fair value of the derivative instruments, which fair values were obtained from the counter-parties, held by the Company at June 30, 2002 were a liability of \$74,000 (included in other liabilities) related to the oil and gas hedges. The ineffective portion of these hedges was not material as of June 30, 2002. Hedging transactions for the three months ended June 30, 2002 decreased oil and gas revenues by \$20,000; hedging transactions for the six months ended June 30, 2002 increased oil and gas revenues by \$263,500 (reclassified from comprehensive income). All obtained oil and gas hedging transactions will expire by the fourth quarter of 2002.

In April 2002, the Company entered into a swap transaction covering 8,000 MMBTU of natural gas per day at a price of \$3.755 per MMBTU and covering the period from May 2002 through December 2002. The swap index is NYMEX Henry Hub. The estimated fair value of the swap transactions at June 30, 2002 was an asset of \$451,000 (included in other current assets). The ineffective portion of these swaps was not material as of June 30, 2002. Swap transactions for the three months ended June 30, 2002 increased oil and gas revenues by \$199,000 (reclassified from comprehensive income).

The Company offsets any gain or loss on the swap and collars contracts with the realized prices for its production. While the swaps and collars reduce the Company's exposure to declines in the market price of natural gas and oil, they also limit the Company's gains from increases in the market price.

As a result of the merger with Southern Mineral, the Company also obtained an interest rate swap position that was originally intended to hedge the variability of interest expense associated with Southern Mineral's variable rate Canadian debt. Under the swap agreement, the Company receives a floating rate of the Canadian prime rate and pays a fixed rate of 5.96% on a notional amount of Canadian \$15 million through August 29, 2003. The interest rate swap does not

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qualify for hedge accounting. The estimated fair value at June 30, 2002 is a liability (included in other liabilities) of \$401,000.

### NOTE 6 - PROPERTY, PLANT AND EQUIPMENT

Investments in property, plant and equipment were as follows at June 30, 2002 and December 31, 2001 (amounts in thousands):

	2002	2001
Oil and gas properties:		
Proved .....	\$ 318,505	\$ 315,935
Unproved .....	1,553	1,223
	320,058	317,158
Plant and related facilities .....	10,439	9,743
Gas gathering facilities .....	1,698	1,698
Furniture, fixtures and equipment .....	-	95
	332,195	328,694
Less - accumulated depreciation, depletion, amortization and impairment .....	(210,664)	(200,242)
	\$ 121,531	\$ 128,452

As more fully described in the Company's 10-K, PetroCorp utilizes the full cost method of accounting for costs related to its oil and natural gas properties. Under this method, capitalized costs are subject to a ceiling test, evaluated each quarter, which limits such pooled costs to the aggregate of the present value of future net revenues attributable to proved oil and gas reserves discounted at 10 percent plus the lower of cost or market value of unproved properties. At June 30, 2002, the Company's unamortized costs of its Canadian oil and gas properties exceeded this ceiling amount by approximately \$4 million (after tax) due to low gas prices in effect at that date. The cash spot price for natural gas in the US and Canada was \$3.21 and \$1.34, respectively, on June 30, 2002. However, due to the subsequent recovery in the market prices for natural gas the Company was not required to record a write-down of its oil and gas properties. A decline in oil and gas prices from current levels, or other factors, without other mitigating circumstances, could cause a future write-down of capitalized costs and a non-cash charge against future earnings.

### NOTE 7 - LONG-TERM DEBT

In July 2000, the Company entered into a \$75 million revolving credit agreement with the Toronto-Dominion Bank (TD Bank), the agent, and the Bank of Nova Scotia. The term of the facility is through April 30, 2003 and the initial borrowing base was set at \$58 million. Borrowings can be funded by either Eurodollar loans or Base Rate loans. The interest rate on the borrowings is equal to an interest rate spread plus either the Eurodollar rate or the Base Rate. The interest spread is determined from a sliding scale based on the Company's borrowing base percentage utilization in effect from time to time. The spread ranges from 1.25 to 2.25 on Eurodollar loans and .25 to 1.25 on Base Rate loans. At June 30, 2002, the weighted average interest rate for loans outstanding under this facility was approximately 4.0%.

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The \$75 million revolving credit agreement prohibits the declaration and payment of dividends on the common stock of the Company. Also, the debt agreement requires, along with other restrictions, the Company to maintain a minimum current ratio, a minimum tangible net worth, and a minimum interest coverage ratio.

Subsequent to quarter end, the Company negotiated a twelve-month extension of the existing credit agreement with TD Bank, as agent, on substantially the same terms as the existing agreement. The extension, which is subject to mutually agreeable documentation, anticipates an increase in the borrowing base to \$70 million. Debt under the credit agreement is therefore reflected as a long-term liability in the financial statements.

### NOTE 8 - GEOGRAPHIC AREA INFORMATION

The principal business of the Company is oil and gas, which consists of the exploration, development, acquisition, exploitation and operation of oil and gas properties and the production and sale of crude oil and natural gas in North America. Pertinent information with respect to the Company's oil and gas business is presented in the following table (in thousands):

	United States	Canada	General Corporate
Three months ended June 30, 2002:			
Revenues .....	\$ 7,794	\$ 5,100	\$ -
Income (loss) from operations.....	2,505	2,209	(671)
Three months ended June 30, 2001:			
Revenues .....	\$ 6,447	\$ 6,309	\$ -
Income (loss) from operations .....	3,052	3,196	(510)
Six months ended June 30, 2002:			
Revenues .....	\$ 13,970	\$ 10,398	\$ -
Income (loss) from operations .....	3,744	3,835	(1,357)
Long-lived assets at June 30 .....	59,867	64,283	82
Six months ended June 30, 2001:			
Revenues .....	\$ 13,041	\$ 13,484	\$ -
Income (loss) from operations .....	7,397	8,776	(989)
Long-lived assets at June 30 .....	83,505	70,091	219

### NOTE 9 - RECENT ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board ("FASB") issued FAS No. 142, Goodwill and Other Intangible Assets, and in August 2001, FAS No. 144, Accounting for Impairment or Disposal of Long-Lived Assets. Effective January 1, 2002, the Company adopted FAS No. 142 and 144. The adoption had no effect on the Company's financial position or results of operations.

In June 2001, the FASB issued FAS No. 143, Accounting for Asset Retirement Obligations. FAS 143 is effective for fiscal years beginning after June 15, 2002 (January 1, 2003 for the Company) and establishes an accounting standard requiring the recording of the fair value of liabilities associated with the retirement of long-lived assets (mainly plugging and abandonment costs for depleted wells) in the period in which the liability is incurred (at the time the wells are drilled). Management is currently evaluating the impact of FAS No.

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143 on the Company's financial position and results of operations.

8

In April 2002, the FASB issued FAS No. 145, Recission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections. FAS No. 145 is effective for fiscal years beginning after May 15, 2002. In July 2002, the FASB issued FAS No. 146, Accounting For Costs Associated with Exit or Disposal Activities, which is effective for exit or disposal activities initiated after December 31, 2002. Management is currently evaluating the impact of FAS No. 145 and 146 on financial position and results of operations.

### NOTE 10 - COMMON STOCK REPURCHASES

On September 14, 2001 the Company announced that the Board of Directors authorized the purchase of up to 1,000,000 shares of the Company's common stock. Through June 30, 2002, 264,607 shares have been purchased at a cost of \$2,350,000, which shares are held in treasury. On July 31, 2002, the Company purchased an additional 40,000 shares at a cost of \$350,000.

9

### Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

#### General

The Company's principal line of business is the production and sale of its oil and natural gas reserves located in North America. Results of operations are dependent upon the quantity of production and the price obtained for such production. Prices received by the Company for the sale of its oil and natural gas have fluctuated significantly from period to period. Such fluctuations affect the Company's ability to maintain or increase its production from existing oil and gas properties and to explore, develop or acquire new properties.

The following table reflects certain operating data for the periods presented:

	For the three months ended June 30,		For six mo ended Ju
	2002	2001	2002
Production:			
United States:			
Oil (MBbls) .....	121	91	246
Gas (MMcf) .....	1,319	905	2,786

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Total gas equivalents (MMcfe) .....	2,045	1,451	4,262
Canada:			
Oil (MBbls) .....	68	42	134
Gas (MMcf) .....	1,532	1,285	3,144
Total gas equivalents (MMcfe) .....	1,940	1,537	3,948
Total:			
Oil (MBbls) .....	189	133	380
Gas (MMcf) .....	2,851	2,190	5,930
Total gas equivalents (MMcfe) .....	3,985	2,988	8,210
Average sales prices:			
United States:			
Oil (per Bbl) .....	\$24.15	\$26.65	\$22.00
Gas (per Mcf) .....	3.17	4.37	2.81
Canada:			
Oil (per Bbl) .....	22.68	22.40	20.25
Gas (per Mcf) .....	2.17	3.37	2.13
Weighted average:			
Oil (per Bbl) .....	23.62	25.31	21.38
Gas (per Mcf) .....	2.63	3.78	2.45
Selected data per Mcfe:			
Average sales price .....	\$3.01	\$3.90	\$2.76
Production costs .....	0.86	0.97	0.88
General and administrative expenses .....	0.17	0.17	0.17
Oil and gas depreciation, depletion and amortization .....	0.99	0.88	0.98

10

### Results of Operations

Three Months Ended June 30, 2002 Compared to Three Months Ended June 30, 2001

Overview. The Company recorded second quarter 2002 net income of \$2,380,000, or \$0.19 per share. This compares to net income of \$2,599,000 or \$0.27 per share recorded in the second quarter of 2001. The decrease in net income results from lower oil and gas prices. Net cash provided by operating activities was \$9.6 million for the quarter ended June 30, 2002 compared to net cash used of \$1.6 million for the corresponding quarter of 2001.

Revenues. Total revenues increased 1% to \$12.9 million in the second quarter of 2002 compared to \$12.8 million in the second quarter of 2001 as a result of increased volumes from the merger with Southern Mineral, offset by lower commodity prices. The Company's natural gas production increased 30% to 2,851 MMcf from 2,190 MMcf and oil production increased 42% to 189 MBbls from 133 MBbls, resulting in the Company's overall equivalent production increasing 33% to 3,985 MMcfe from 2,988 MMcfe. The increase in oil and gas production is primarily due to the merger with Southern Mineral as well as several new wells coming on-line in Canada.

The Company's composite average oil price decreased 7% to \$23.62 per barrel in the second quarter of 2002 from \$25.31 per barrel in the second quarter of 2001. The Company's average U.S. natural gas price decreased 27% to \$3.17 per Mcf in the second quarter of 2002 from \$4.37 per Mcf in the prior year quarter, while the average Canadian natural gas price decreased 36% to \$2.17 per Mcf in the second quarter of 2002 from \$3.37 per Mcf for 2001. The significant decrease in gas prices, offset by the increase in volumes from the merger with Southern Mineral, resulted in a 3% increase in oil and gas revenues to \$12.0 million in

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the second quarter of 2002 from \$11.7 million in the prior year.

**Production Costs.** Production costs increased 17% to \$3.4 million in the second quarter of 2002 as a result of the costs associated with the additional wells acquired in the merger with Southern Mineral. Production costs per Mcfe decreased by 11% to \$0.86 per Mcfe in the second quarter of 2002, primarily due to decreased production taxes related to lower commodity prices, processing credits received in connection with the annual throughput evaluation for the Hanlan plant in Canada, and lower non-recurring workover and maintenance costs.

**Depreciation, Depletion & Amortization (DD&A).** Total DD&A increased 49% to \$4.4 million in the second quarter of 2002. The composite oil and gas DD&A rate increased 13% to \$.99 per Mcfe from \$0.88 per Mcfe. This reflects the impact of the cost of the Southern Mineral properties added to the full cost pool.

**General and Administrative Expenses.** General and administrative expenses increased 31% to \$671,000 in the second quarter of 2002 from \$511,000 in the second quarter of 2001 due to higher fees paid to Kaiser-Francis for the management of the additional Southern Mineral properties.

**Investment Income.** Investment income increased 9% to \$61,000 in the second quarter of 2002 from \$56,000 in the second quarter of 2001.

**Interest Expense.** Interest expense increased 39% to \$626,000 in the second quarter of 2002 from \$449,000 in the prior year quarter, reflecting the increase in outstanding debt due to the merger with Southern Mineral. The Liquidity and Capital Resources section further describes changes in debt.

**Other Income.** Other income increased to \$291,000 in the second quarter of 2002 compared to a loss of \$1,053,000 in the prior year quarter. The income and loss, respectively, are primarily due to realized translation gains and losses.

**Income Taxes.** The Company recorded a \$1,389,000 income tax expense with an effective tax rate of 37% on a pre-tax income of \$3,769,000 in the second quarter of 2002. This compares to an income tax expense of \$1,693,000 with an effective tax rate of 39% on pre-tax income of \$4,292,000 in the second quarter of 2001. The lower effective tax rate is primarily due to reduced tax rates in Canada.

11

### Six Months Ended June 30, 2002 Compared to Six Months Ended June 30, 2001

**Overview.** The Company recorded a first half 2002 net income of \$3,426,000, or \$0.27 per share. This compares to net income of \$8,805,000, or \$0.95 per share recorded in the first half of 2001. This decrease results primarily from lower oil and gas prices. Net cash provided by operating activities was \$12.1 million for the six months ended June 30, 2002 compared to \$12.5 million for the corresponding half of 2001.

**Revenues.** Total revenues decreased 8% to \$24.4 million in the first six months of 2002 compared to \$26.5 million in the first half of 2001, primarily due to commodity price decreases. The Company's natural gas production increased 45% to 5,930 MMcf from 4,095 MMcf and oil production increased 67% to 380 MBbls from 227 MBbls, resulting in the Company's overall equivalent production increasing 50% to 8,210 MMcfe from 5,457 MMcfe. The increase in natural gas production is primarily the result of the merger with Southern Mineral as well

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as several new wells coming on-line in both Canada and the US. The increase in oil production also reflects the merger with Southern Mineral.

The Company's composite average oil price decreased 18% to \$21.38 per barrel in the first half of 2002 from \$25.92 per barrel in the first six months of 2001. The Company's average U.S. natural gas price decreased 46% to \$2.81 per Mcf in the first six months of 2002 from \$5.24 per Mcf in the prior year, while the average Canadian natural gas price decreased 50% to \$2.13 per Mcf in the first half of 2002 from \$4.23 per Mcf in 2001. The significant decrease in oil and gas prices, partially offset by increased production volumes, resulted in a 9% decrease in oil and gas revenues to \$22.7 million in the first six months of 2002 from \$24.9 million in the same period of 2001.

**Production Costs.** Production costs increased 60% to \$7.2 million in the first half of 2002 as a result of additional wells acquired in the merger with Southern Mineral. Production costs per Mcfe increased 7% to \$0.88 per Mcfe in the first half of 2002 from \$0.82 in the same six months of 2001 primarily because Southern Mineral properties acquired have higher processing costs related to heavy oil in Canada and high sulfur production in Alabama.

**Depreciation, Depletion & Amortization (DD&A).** Total DD&A increased 71% to \$8.9 million in the first half of 2002 from \$5.2 million in the first six months of 2001. The composite oil and gas DD&A rate increased 20% to \$.98 per MMcfe from \$0.82 per MMcfe. This reflects the impact of the cost of the Southern Mineral properties added to the full cost pool.

**General and Administrative Expenses.** General and administrative expenses increased 37% to \$1,357,000 in the first six months of 2002 from \$990,000 in the first half of 2001 due to higher fees paid to Kaiser-Francis for the management of the additional Southern Mineral properties.

**Investment Income.** Investment income decreased 3% to \$91,000 in the first half of 2002 from \$94,000 in the first six months of 2001 due to lower interest rates.

**Interest Expense.** Interest expense increased 103% to \$1,355,000 in the first six months of 2002 from \$668,000 in the prior year first half, reflecting the impact higher debt levels over most of the period. The Liquidity and Capital Resources section further describes changes in debt.

**Other Income.** Other income increased 102% to \$454,000 in the first half of 2002 from \$225,000 for the corresponding period in 2001. The increase is primarily due to a mark-to-market adjustment on the interest rate hedge.

**Income Taxes.** The Company recorded a \$1,986,000 income tax expense with an effective tax rate of 37% on pre-tax income of \$5.4 million in the first half of 2002. This compares to an income tax expense of \$6,030,000 with an effective tax rate of 41% on pre-tax income of \$14.8 million in the first half of 2001. The lower effective tax rate is due to lower tax rates in Canada and the impact that reduced commodity prices have on non-deductible Crown royalties and the resource allowance deduction in the calculation of Canadian income taxes.

### Liquidity and Capital Resources

As of June 30, 2002, the Company had working capital of \$8.2 million as

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compared to \$4.0 million at December 31, 2001. Net cash provided by operating activities was \$12.1 million for the six months ended June 30, 2002 compared to \$12.5 million for the corresponding six months of 2001.

The Company's total capital expenditures were \$4.3 million and \$64.0 million, which includes the Southern Mineral acquisition (\$25.0 million cash expenditures, of which \$19.8 relate to the Southern Mineral acquisition), for the six months ended June 30, 2002 and 2001, respectively, primarily related to the acquisition of Southern Mineral in 2001 and exploration and development in both years.

In the first six months of 2002 sales of oil and gas properties totaled \$150,000. There were no corresponding sales in the first six months of 2001.

In July 2000, the Company entered into a \$75 million revolving credit agreement with the Toronto-Dominion Bank (TD Bank), the agent, and the Bank of Nova Scotia. The term of the facility is through April 30, 2003 and the initial borrowing base was set at \$58 million. Borrowings can be funded by either Eurodollar loans or Base Rate loans. The interest rate on the borrowings is equal to an interest rate spread plus either the Eurodollar rate or the Base Rate. The interest spread is determined from a sliding scale based on the Company's borrowing base percentage utilization in effect from time to time. The spread ranges from 1.25 to 2.25 on Eurodollar loans and .25 to 1.25 on Base Rate loans. At June 30, 2002, the Company had a total of \$42.4 million outstanding under the revolver and \$15.6 million available based on the current borrowing base, as defined, subject to certain limitations. During the first half of 2002, the average interest rate under this facility was approximately 4.2%.

Subsequent to quarter end, the Company negotiated a twelve-month extension of the existing credit agreement with TD Bank, as agent, on substantially the same terms as the existing agreement. The extension, which is subject to mutually agreeable documentation, anticipates an increase in the borrowing base to \$70 million. Debt under the credit agreement is therefore reflected as a long-term liability in the financial statements.

The Company has historically funded its capital expenditures and working capital requirements with its cash flow from operations, debt and equity capital and participation by institutional investors. If the Company increases its capital expenditure level in the future or operating cash flow is not as expected, capital expenditures may require additional funding, obtained through borrowings from commercial banks and other institutional sources or by public or private offerings of equity or debt securities.

### Common Stock Repurchases

On September 14, 2001 the Company announced that the Board of Directors authorized the purchase of up to 1,000,000 shares of the Company's common stock. Through June 30, 2002, 264,607 shares have been purchased at a cost of \$2,350,000, which shares are held in treasury. On July 31, 2002, the Company purchased an additional 40,000 shares at a cost of \$350,000.

### Other

In June 2001, the Financial Accounting Standards Board ("FASB") issued FAS No. 142, Goodwill and Other Intangible Assets, and in August 2001, FAS No. 144, Accounting for Impairment or Disposal of Long-Lived Assets. Effective January 1, 2002, the Company adopted FAS No. 142 and 144. The adoption had no effect on the Company's financial position or results of operations.

In June 2001, the FASB issued FAS No. 143, Accounting for Asset Retirement Obligations. FAS 143 is effective for fiscal years beginning after June 15, 2002 (January 1, 2003 for the Company) and establishes an accounting standard



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requiring the recording of the fair value of liabilities associated with the retirement of long-lived assets (mainly plugging and abandonment costs for depleted wells) in the period in which the liability is incurred (at the time the wells are drilled). Management is currently evaluating the impact of FAS No. 143 on the Company's financial position and results of operations.

13

In April 2002, the FASB issued FAS No. 145, Recission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections. FAS No. 145 is effective for fiscal years beginning after May 15, 2002. In July 2002, the FASB issued FAS No. 146, Accounting For Costs Associated with Exit or Disposal Activities, which is effective for exit or disposal activities initiated after December 31, 2002. Management is currently evaluating the impact of FAS No. 145 and 146 on financial position and results of operations.

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

The Company's primary sources of market risk are from fluctuations in commodity prices, interest rates and exchange rates.

#### Commodity Price Risk

The Company produces and sells natural gas, crude oil, condensate, natural gas liquids and sulfur. As a result, the Company's financial results can be significantly affected as these commodity prices fluctuate widely in response to changing market forces. The Company utilizes hedging transactions to manage a portion of its exposure to price fluctuations on its sales of oil and natural gas. A change in commodity prices of \$.10 per MCF of natural gas and \$1.00 per barrel of oil would cause the company's annual income from operations to change by \$1,675,000.

The merger with Southern Mineral resulted in PetroCorp assuming crude oil and natural gas costless collars. The impact of hedging transactions for the six months ended June 30, 2002 was an increase in oil and gas revenues of \$263,500. The fair value at June 30, 2002 of the crude oil and natural gas collars was a liability of \$74,000. All assumed oil and gas hedging transactions will expire by the fourth quarter of 2002.

In April 2002, the Company entered into a swap transaction covering 8,000 MMBTU of natural gas per day at a price of \$3.755 per MMBTU and covering the period from May 2002 through December 2002. The swap index is NYMEX Henry Hub. The estimated fair value of the swap transactions at June 30, 2002 was an asset of \$451,000.

#### Interest Rate Risk

As a result of the merger with Southern Mineral, the Company assumed an interest rate swap position that was originally intended to hedge the variability of interest expense associated with Southern Mineral's variable rate Canadian debt. Under the swap agreement, the Company receives a floating rate of the Canadian prime rate and pays a fixed rate of 5.96% on a notional amount of Canadian \$15 million through August 29, 2003. The interest rate swap does not qualify for hedge accounting at June 30, 2002 and the Company has recorded the swap's fair value of \$192,000 as a liability at the date of the merger. The estimated fair value at June 30, 2002 is a liability of \$401,000.

PART II. OTHER INFORMATION

Item 1 - Legal Proceedings

Not Applicable

Item 2 - Changes in Securities

Not Applicable

Item 3 - Defaults upon Senior Securities

Not Applicable

Item 4 - Submission of Matters to Vote of Security Holders

(A) May 23, 2002 Annual shareholders meeting

(1) Election of Gary R. Christopher and Steven R. Berlin as directors of the Company

Number of Votes		
For	Against	Abstentions and Broker Non-Votes
9,921,499	2,000	217,411

Item 5 - Other Information

Not Applicable

Item 6 -

(a) Exhibits

Not Applicable

(b) Reports on Form 8-K

Not Applicable

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SIGNATURES

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 duly authorized officer.

PETROCORP INCORPORATED

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(Registrant)

Date: August 13, 2002

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/s/ STEVEN R. BERLIN

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Steven R. Berlin  
Chief Financial Officer and Secretary  
(On behalf of the Registrant and as the  
Principal Financial Officer)