

# **PETROCORP GROUP INC.**

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**FOR THE YEAR ENDED MARCH 31, 2011**

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The following Management Discussion and Analysis (MD&A) is based on the March 31, 2011 consolidated financial statements, prepared in accordance with Generally Accepted Accounting Principles ("GAAP"), and is provided to assist readers in understanding the financial performance of PetroCorp Group Inc., ("PetroCorp" or the "Corporation") during the period(s) presented. This MD&A is dated July 27, 2011.

The following MD&A should be read in conjunction with the audited consolidated financial statements and notes thereto for the years ended March 31, 2011 and 2010.

All values expressed in this document are in Canadian dollars, except for charts and/or graphs which are in thousands of Canadian dollars.

**FORWARD LOOKING STATEMENTS**

The following discussion contains certain forward-looking statements, including management's assessment of future plans, expenses, taxes, payments and liabilities under the APAs (as defined herein), the amount of the distribution of proceeds from the APAs to the shareholders, and the timing thereof, and the completion of the Follow-on Transaction (as defined herein) and the timing thereof, that involve substantial known and unknown risks, assumptions and uncertainties, certain of which are beyond the Corporation's control. Readers are cautioned that the foregoing list of factors is not exhaustive. All subsequent forward-looking statements, whether written or oral, attributable to PetroCorp or persons acting on its behalf are expressly qualified in their entirety by these cautionary statements. Furthermore, the forward-looking statements contained in this document are made as of the date of this document and PetroCorp does not undertake any obligation to update publicly or to revise any of the included forward-looking statements, whether as a result of new information, future events or otherwise, except as may be required by applicable securities laws.

**DESCRIPTION OF THE BUSINESS**

At the present time the Corporation is an inactive company with no ongoing business operations. The Corporation's primary responsibility is to collect the funds payable pursuant to the terms of the APAs (as defined herein), and to administer the funds for distribution or other investment.

**GOING CONCERN**

The financial statements and MD&A have been prepared using generally accepted accounting principles applicable to a going concern, which assumes that the Corporation will be able to realize its assets and discharge its liabilities and commitments in the normal course of operations for the foreseeable future. At March 31, 2011, the Corporation had no ongoing business operations, and subsequent to March 31, 2011, the Corporation is party to a claims notice, an indemnity notice, and a statement of claim for an amount in excess of the total assets of the Company (see Note 15). As a result, there is significant doubt as to the ability of the Corporation to continue as a going concern. The Corporation's ability to continue as a going concern is dependent upon the resolution of these claims. Realization values may be substantially different from carrying values shown and the financial statements do not give effect to the adjustments that would be necessary to the carrying values and classification of assets and liabilities, should the Corporation be unable to continue as a going concern. Such adjustments may be material.

**DISCONTINUED OPERATIONS**

On October 21, 2009, the Corporation signed an agreement to sell substantially all of the assets of the Corporation and its affiliates to Powell (as defined herein) for total cash consideration of up to \$33.5 million. On December 15, 2009, the shareholders of the Corporation approved the Transaction (as defined herein) which closed with an effective date of that same date. PetroCorp entered into three (3) Asset Purchase Agreements (collectively the "APAs"), with three subsidiaries of Powell Industries Inc. (collectively, "Powell") of Houston, Texas. The APAs provided for the sale of substantially all of the Corporation's assets (the "Transaction"), including, but not limited to, the operating business units, trade names, inventory, leases, most liabilities, and personnel.

The closing of the acquisition of PetroCorp's interest in a joint venture operating in Kazakhstan (the "PCKO JV") was conditional upon obtaining regulatory approval from the Kazakhstan Government. This decision was received prior to March 31, 2010, and the sale of the PCKO JV closed effective April 1, 2010. Conditions were removed and consideration of \$2.5 million was received on June 1, 2010 after several Republic of Kazakhstan approvals were completed. During the year ended March 31, 2011, the Corporation paid Powell \$0.5 million in settlement of a net asset purchase price adjustment pursuant to the APAs related to the close of the PCKO JV.

Powell acquired substantially all of the assets of the Corporation and its affiliates for cash consideration of up to \$33.5 million subject to adjustments, with \$19.6 million received by the Corporation upon closing, an additional \$5.9 million dollars paid by Powell into escrow to be released after specific time periods are met and conditions are satisfied (\$2.5 million held in escrow payable upon the closing of the sale of the Corporation's interest in the PCKO JV, \$3.0 million held in escrow payable over a period of twenty-five months, and \$0.4 million held in escrow as security on credit cards during a transitional period), and up to \$8.0 million payable contingent on the operations of PowerComm achieving specified performance thresholds for the twelve months ending March 31, 2010. Powell also assumed certain liabilities of PetroCorp including bank debt, accounts payable and obligations under capital leases of approximately \$26.4 million.

During the year ended March 31, 2011, the deferred purchase price payment pursuant to the APAs between the Corporation and Powell was settled. The APAs provided for a deferred purchase price payment of up to \$8.0 million contingent on the operations of the Corporation sold to the Powell achieving specified performance thresholds, which thresholds were not met. Accordingly, there are no proceeds owing to the Corporation relating to deferred purchase price payments.

The proceeds of the Transaction have been measured at the exchange amount and resulted in a gain of approximately \$8.6 million, net of expenses and known purchase price adjustments related to the Transaction during the year ended March 31, 2010. The gain on sale consists of the following (000's):

	Year Ended March 31, 2010	Year Ended March 31, 2011	Total
Proceeds <sup>1</sup> :			
Cash consideration received	\$ 19,590	\$ 4,910	\$ 24,500
Cash consideration paid into escrow <sup>2</sup>	5,910	(4,910)	1,000
Net asset adjustment <sup>3</sup>	(779)	(500)	(1,279)
Liabilities assumed by Powell <sup>3</sup>	<u>26,376</u>	<u>-</u>	<u>26,376</u>
	\$ 51,097	\$ (500)	\$ 50,597
Less:			
Assets disposed of to Powell <sup>3</sup>	(39,597)	-	(39,597)
Net adjustment on settlement of specific receivable	(1,773)	-	(1,773)
Additional closing costs <sup>4</sup>	<u>(1,165)</u>	<u>(72)</u>	<u>(1,237)</u>
Net gain recorded on disposal of assets <sup>5</sup>	\$ <u>8,562</u>	\$ <u>(572)</u>	\$ <u>7,990</u>

<sup>1</sup> Contingent gain of \$8,000,000 related to the deferred purchase payment had not been reflected as settlement had not yet been determined as at March 31, 2010. During the year ended March 31, 2011 settlement was reached, with no deferred purchase payment owing from Powell to the Corporation.

<sup>2</sup> Escrow funds have now been settled, with \$1,000,000 outstanding at the date of this report as per the terms of the APAs.

- <sup>3</sup> Powell assumed approximately an additional \$1,014,000 in taxes related to the PCKO JV, which was settled through the net asset value adjustment mechanism in the APAs, as opposed to treating as an excluded liability as originally contemplated by the APAs, resulting in a \$779,000 net asset value adjustment. During the year ended March 31, 2011, settlement was reached on a \$500,000 net asset value adjustment with respect to the close of the PCKO JV on April 1, 2010.
- <sup>4</sup> No allocation of professional fees incurred subsequent to March 31, 2010 has been made to the gain on sale and/or discontinued operations. The \$72,000 additional closing costs incurred in the year ended March 31, 2011 relate specifically to payments made in settlement of two claims in existence at the time of the asset sale to Powell, which the Corporation was responsible for.
- <sup>5</sup> Unknown, unquantifiable and/or unsettled adjustments have not been reflected in the calculation of the gain on sale.

The following table details the assets and liabilities of discontinued operations for the periods presented herein:

\$ thousands	March 31 2011	March 31 2010
Future income taxes	-	\$ 32
Current and total assets of discontinued operations	-	\$ 32
Future income taxes	-	\$ 362
Current and total liabilities of discontinued operations	-	\$ 362

All of the operations and substantially all of the assets and liabilities of the Corporation were disposed as part of the Transaction. Excluded assets and liabilities, as defined in the APAs, will accordingly remain as assets and obligations of the Corporation.

For reporting purposes, the results of operations from operating activities related to discontinued operations are as follows:

\$ thousands	March 31 2011	March 31 2010
Revenue	-	\$ 47,657
Costs and other expenses	\$ 572	42,775
Depreciation and amortization	-	1,208
Interest expense	-	677
Moving costs	-	-
Impairment of goodwill	-	-
Other expense (income)	-	275
Operating income (loss)	(572)	2,722
Gain on the sale of discontinued operations	-	8,562
Other comprehensive income (loss)	-	(31)
Income tax recovery (expense)	79	(1,166)
Income (loss) from discontinued operations, net of tax	\$ (493)	\$ 10,087

Subsequent to the year ended March 31, 2010, only specific adjustments settled as per the terms of the APAs have been disclosed within discontinued operations. All other professional fees and ongoing costs, including those incurred as a direct or indirect result of settling the APAs have been disclosed in the operating results of the Corporation.

During the year ended March 31, 2011, two litigation claims from fiscal 2009 were settled for approximately \$72,000, which the Corporation is responsible for under the terms of the APAs. In addition, \$500,000 was paid to Powell in settlement of a net asset purchase price adjustment relating specifically to PCKO, under the terms of the APAs.

Pursuant to the APAs, the Corporation ceased its operating business save and except for its interest in the PCKO JV, which at that time was conditional upon obtaining the approval of the Kazakhstan government, with the funds allocated to that closing held in escrow. The approval from the Kazakhstan Government was received prior to March 31, 2010, and the PCKO JV formally closed with an effective date of April 1, 2010, upon completion of related filings and approvals. Powell managed these operations on behalf of the Corporation, pursuant to the PCKO Transition Services Agreement, dated December 15, 2009, up to April 1, 2010. The transaction met the held for sale disclosure requirements as at March 31, 2010, and accordingly, had been disclosed as part of the discontinued operations during that year.

As a result of the Transaction the Corporation does not have any operating business at this time.

## HIGHLIGHTS OF THE YEAR ENDED MARCH 31, 2011

The sale of the PCKO JV closed effective April 1, 2010. Conditions were removed and consideration of \$2,500,000 was received on June 1, 2010 after several Republic of Kazakhstan approvals were completed. During the quarter ended December 31, 2010, \$500,000 was released from escrow, and received by the Corporation as per the terms of the APAs. All escrow funds have been settled to date, with the exception of \$1,000,000, which remains outstanding as per the terms of the APAs.

On May 13, 2010 the Corporation entered into a stand-by purchase agreement (the "Stand-By Agreement") in connection with a rights offering (the "Offering") of Petrowest Energy Services Trust (the "Trust"). Pursuant to the Stand-By Agreement, the Corporation had agreed to purchase a minimum of \$1,500,000 of units of the Trust (the "Units") and up to a maximum of \$2,500,000 of Units. The Corporation was acting as part of a total stand-by commitment for \$7,500,000 of Units not otherwise subscribed for under the Offering. On June 29, 2010, the Offering closed, with the Corporation fully subscribing for its \$2,500,000 commitment, being a subscription for 17,857,143 Units. The Corporation accounts for its investment in the Trust as an available-for-sale financial asset.

Discussions regarding the potential for a transaction to combine the business of the Trust and the Corporation through a plan of arrangement or other similar transaction (a "Follow-on Transaction") have ended without an agreement, and accordingly the Units were distributed to the Corporation's shareholders of record as at December 15, 2010, as a return of capital distribution. The fair market value of the Units was determined to be \$2,857,143 (\$0.16 per Unit), based on the 5 day trading average to December 15, 2010. Excluding costs and professional fees, a gain of \$357,143 was reflected by the Corporation as a result of this distribution.

In addition to the Units, and as consideration for participating in the Stand-By Agreement, the Corporation was issued 1,903,452 warrants in the Trust, allowing the Corporation to acquire one Unit for each warrant held. The warrants are exercisable at a price of \$0.1879 per warrant, and expire at the end of business on June 29, 2011. As at March 31, 2011, the estimated fair value of the warrants was \$382,594 using the Black-Scholes pricing model, assuming a life of 1 year from the date of issue, 150% volatility, and an average risk free rate of 1%. The Corporation accounts for its investment in the Trust as an available-for-sale financial asset, and is re-measured at fair value each reporting period.

The Corporation is currently being managed by two individuals, to collect on the remaining proceeds, if any, and to settle the remaining obligations as a result of the Transaction; to continue to meet the Corporation's obligations as an ongoing legal entity and reporting issuer, and to pursue alternatives with respect to the future opportunities of the Corporation.

**QUARTERLY INFORMATION AND FOURTH QUARTER CONSOLIDATED RESULTS**

The following table sets forth selected quarterly information for the Corporation for the past eight quarters:

\$ thousands, except per share data	Mar 31, 2011	Dec 31, 2010	Sep 30, 2010	Jun 30, 2010
Earnings (loss) from continuing operations	\$ 243	\$ (26)	\$ (151)	\$ (184)
Earnings (loss) per share from continuing operations, basic and diluted	0.00	0.00	0.00	0.00
Earnings (loss) from discontinued operations	79	-	\$ (509)	\$ (63)
Earnings (loss) per share from discontinued operations, basic and diluted	0.00	0.00	(0.01)	0.00
Per share distribution as a special dividend	-	-	-	-
Per share distribution as a return of capital	-	0.04	-	-

\$ thousands, except per share data	Mar 31, 2010	Dec 31, 2009	Sep 30, 2009	Jun 30, 2009
Earnings (loss) from continuing operations	\$ (193)	\$ (39)	-	-
Earnings (loss) per share from continuing operations, basic and diluted	-	-	-	-
Earnings (loss) from discontinued operations	\$ (1,691)	\$ 9,894	\$ 1,876	\$ 8
Earnings (loss) per share from discontinued operations, basic and diluted	(0.03)	0.14	0.03	0.00
Per share distribution as a special dividend	0.11	-	-	-
Per share distribution as a return of capital	-	-	-	-

The Corporation's results may vary between periods due to a number of factors, including the disposal of substantially all of the Corporations assets on December 15, 2009 and the corresponding reclassification to discontinued operations, and as a result of the timing of settlement of various adjustments under the terms of the APAs. As the Corporation currently has no ongoing business operations, the historical results and special distributions should not be used as predictive indicators for future expectations.

**TOTAL ASSETS AND LIABILITIES**

At March 31, 2011, total assets were \$8,222,000; down from \$13,543,000 at March 31, 2010, resulting from the investment and later distribution of Units in the Trust (\$2,500,000), payment in settlement of the net asset value adjustment with Powell relating to the PCKO JV and settlement of prior legal claims (\$572,000), and the approximate settlement of obligations from the transaction and ongoing general and administrative costs (\$2,600,000). These asset reductions have been offset by the fair value of the Trust warrants held as at March 31, 2011 (\$383,000). Almost all of the assets as at March 31, 2011 are in the form of cash, cash equivalents, or funds held in escrow pursuant to the terms of the APAs. The Corporation continues to manage the cash in a conservative manner. Total Liabilities as at March 31, 2011 were \$127,000, which is comprised primarily of income taxes payable, and other accounts payable. No accrual has been made for potential purchase price adjustments, or other ongoing expenses required to maintain the Corporations existence as a reporting issuer.

**LIQUIDITY AND CAPITAL RESOURCES**

Currently the Corporation's assets are primarily in cash and are invested in short term, low risk interest bearing investments with a Canadian Financial Institution. The Corporation was party to a letter of credit on behalf of the

PCKO JV, and placed approximately \$1,300,000 in low risk, interest bearing funds, to be held as security against the letter of credit during the period ended March 31, 2010. During the year ended March 31, 2011, the \$1,300,000 security for the letter of credit, was released to the Corporation. Upon release of these funds, and with mutual agreement with Powell, approximately \$1,300,000 million was paid to Powell in settlement of specific excluded liabilities under the terms of the APAs.

## **OUTSTANDING SHARE DATA**

As at March 31, 2011, and the date hereof, the Corporation had 72,323,254 common shares outstanding. As at March 31, 2011, and the date hereof, PetroCorp had stock options outstanding to purchase 3,105,000 common shares.

## **OFF-BALANCE SHEET ARRANGEMENTS**

PetroCorp Group Inc. has no off-balance sheet arrangements.

## **TRANSACTIONS WITH RELATED PARTIES**

There are no related party balances outstanding at March 31, 2011. A total of \$80,000 (\$30,000 – 2010) in consulting fees were paid to related parties for the year ended March 31, 2011.

## **OUTLOOK**

The Corporation has no operating business at this time and it is operating at minimum levels. The intent is to determine the actual financial position of the Corporation when all closing thresholds from the APAs are complete. Provision for taxes and potential distributions are all subject to the final closing proceeds from the APAs.

The Corporation has put in place a management team to manage the ongoing business of the Corporation, including monitoring the Corporation's rights and obligations under the APAs, preparing and filing tax returns, and preparing the documentation required to maintain the Corporation's status as a reporting issuer. The Board of Directors will finalize the plans of the Corporation after the proceeds from the Transaction, the taxes and ongoing obligations of the Corporation can reasonably be determined. A portion of the proceeds from the Transaction will not be payable for up to 25 months from the closing during which time the Corporation must maintain its existence, so the plans may include a reorganization or some other form of transaction.

## **CRITICAL ACCOUNTING ESTIMATES**

In preparing the Consolidated Financial Statements, management is required to make certain assumptions and estimates that affect the reported amounts of the Corporation's operating results and financial condition. The actual results may differ from the estimates that were reported in previous periods. The following is included in the MD&A to assist the reader in assessing the critical accounting policies and practices of the Corporation, as well as aid the reader in assessing the likelihood of materially different results being reported depending on management's assumptions and changes in prevailing conditions which affect the application of these policies and practices. Significant accounting policies are disclosed in Note 2 of the March 31, 2011 annual Consolidated Financial Statements.

### **ALLOWANCE FOR DOUBTFUL ACCOUNTS**

The Corporation performs ongoing monitoring of the operations of the businesses sold to Powell under the APAs. The Corporation is potentially financially responsible for receivables that remain outstanding after a defined period of time elapses, under the terms of the APAs.

## FAIR VALUES OF STOCK OPTIONS AND WARRANTS

Determining the fair value of stock options and warrants also requires significant judgement. Management estimates the fair value using the Black-Scholes pricing model.

## SUBSEQUENT EVENTS

Subsequent to the year ended March 31, 2011, the Corporation received a claims notice and an indemnity notice from Powell, claiming a total of approximately \$8,500,000 in damages related to the APAs (the "Powell Claim"). After reviewing the Powell Claim, the Corporation has filed a dispute notice, and an objection to the claims notice, in dispute of the entire amount of the Powell Claim. As part of the Powell Claim, Powell has issued a claim against the escrow funds of \$1,000,000. On July 11, 2011, a statement of claim was filed in relation to this matter claiming damages of \$9,000,000. The Corporation has not yet responded to this claim. The likelihood of proceeding to litigation, the quantification of settlement, and the realization of the escrow funds are uncertain at this time.

On June 29, 2011, the Corporation exercised its option to purchase 1,903,452 units in the PetroWest Energy Services Trust for total proceeds of \$357,659.

## CHANGES IN ACCOUNTING POLICIES

There were no changes in accounting policies during the year ended March 31, 2011.

## FUTURE ACCOUNTING POLICIES

### INTERNATIONAL FINANCIAL REPORTING STANDARDS

In January 2006, the Accounting Standards Board ("AcSB") of the Canadian Institute of Chartered Accountants adopted a strategic plan for the direction of accounting standards in Canada. On February 13, 2008, the AcSB confirmed that effective for interim and annual financial statements related to fiscal years beginning on or after January 1, 2011, International Financial Reporting Standards ("IFRS") will replace Canada's current Generally Accepted Accounting Principles ("GAAP") for all publicly accountable profit-oriented enterprises. Thus, the transition from GAAP to IFRS will be applicable for the Corporation's first quarter of 2012, at which time the Corporation will prepare both its fiscal 2012 and fiscal 2011 comparative financial information using IFRS.

The Corporation started its IFRS conversion project in 2008, and established a team consisting of internal and external personnel to: gather overall knowledge surrounding IFRS; to identify the major differences between Canadian GAAP and IFRS, specifically within the environment of the Corporation; and to develop a plan for integration and migration. Subsequent to the commencement of this project, the disposal of the substantially all of the assets and liabilities of the Corporation significantly changed the operations and reporting thereon, and the project was put on hold. In the first quarter of 2011, the Corporation used internal resources to understand, identify and assess the overall effort required to adopt IFRS. The Corporation concluded that it would proceed in 2011 preparing for the change using internal resources, but relying on the expertise of external consultants for advice and to review conclusions reached.

The Corporation plans to adopt IFRS according to the schedule recommended by the AcSB.

In addition to an increase in the amount of general disclosure involved, based on the work done to date, the Corporation expects the greatest potential impact of IFRS adoption to be within the Initial Adoption Options under IFRS 1 and the method of accounting for share based payments in accordance with IFRS 2.

The Corporation has evaluated the options and potential exemptions available to it upon initial adoption of IFRS. The recommendations on policy elections will be presented to the Audit Committee for approval. Preliminary



decisions on such topics as the presentation of the financial reports will be made final in 2011, in preparation for both the 2012 year of adoption of the IFRS standards and the required restatement of the 2011 reports. While these decisions will affect how the information in reports prepared by the Corporation will be presented, they will not result in any substantive changes.

IFRS requires Corporations to recognize compensation cost based on the number of awards expected to vest, while under Canadian GAAP, compensation cost was recognized assuming all options granted will vest and forfeitures were recognized as they occurred. The Corporation will assess the impact of this difference between Canadian GAAP and IFRS and this will be part of the work required to restate the 2011 financial statements in order to compare them with the IFRS compliant in the 2012 reports.

In summary, the Corporation will be on schedule to make the required changes to meet the IFRS standards in its accounting in March 31, 2012 and does not expect that the results will be substantially different from results under the GAAP standards under which the Corporation reported in 2011.

## **BUSINESS RISKS**

The Corporation operates as a holding company and therefore has minimal risk. The largest risk is that it may not receive the maximum funds possible pursuant to the APAs due to the various purchase price adjustment mechanisms as defined in the APAs and related documents. The Corporation is subject to specific representations and warranties under the terms of the APAs with Powell. A claim has been filed with respect to these representations and warranties, as noted in the subsequent events section above.

## **ADDITIONAL INFORMATION**

Additional information relating to PetroCorp Group Inc. may be found on the SEDAR website by visiting [www.sedar.com](http://www.sedar.com).