

MERCER INTERNATIONAL INC.

Form 10-Q

August 09, 2007

UNITED STATES  
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, 2007**

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

**Commission File No.: 000-51826**

**MERCER INTERNATIONAL INC.**

*(Exact name of Registrant as specified in its charter)*

**Washington**

*(State or other jurisdiction  
of incorporation or organization)*

**Suite 2840, 650 West Georgia Street, Vancouver, British Columbia, Canada, V6B 4N8**

*(Address of office)*

**(604) 684-1099**

*(Registrant's telephone number, including area code)*

**47-0956945**

*(I.R.S. Employer  
Identification No.)*

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  NO

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES  NO

The Registrant had 36,285,027 shares of common stock outstanding as at August 7, 2007.

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**PART I. FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**MERCER INTERNATIONAL INC.**

**CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**

**FOR THE SIX MONTHS ENDED JUNE 30, 2007**

**(Unaudited)**

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**MERCER INTERNATIONAL INC.**  
**CONSOLIDATED CONDENSED BALANCE SHEETS**  
**As at June 30, 2007 and December 31, 2006**  
**(Unaudited)**  
**(Euros in thousands)**

	<b>June 30, 2007</b>	<b>December 31, 2006</b>
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents	48,302	69,367
Receivables	104,494	75,022
Note receivable, current portion	5,834	7,798
Inventories (Note 4)	94,891	62,857
Prepaid expenses and other	5,462	4,662
Current assets of discontinued operations (Note 10)	1,104	2,094
 Total current assets	 260,087	 221,800
Long-Term Assets		
Cash restricted	45,000	57,000
Property, plant and equipment	968,830	972,143
Investments	88	1
Unrealized foreign exchange rate derivative gain		5,933
Deferred note issuance and other costs	6,294	6,984
Deferred income tax	18,670	29,989
Note receivable, less current portion	4,506	8,744
	1,043,388	1,080,794
 Total assets	 1,303,475	 1,302,594
 <b>LIABILITIES</b>		
Current Liabilities		
Accounts payable and accrued expenses	100,970	84,173
Debt, current portion	33,364	33,903
Current liabilities of discontinued operations (Note 10)	651	1,926
 Total current liabilities	 134,985	 120,002
Long-Term Liabilities		
Debt, less current portion (Note 8)	848,990	873,928
Unrealized interest rate derivative loss	17,570	41,355
Pension and other post-retirement benefit obligations (Note 6)	18,940	17,954
Capital leases	6,457	6,202
Deferred income tax	24,565	22,911

Other long-term liabilities	3,617	1,441
	920,139	963,791
Total liabilities	1,055,124	1,083,793
Minority Interest		
<b>SHAREHOLDERS EQUITY</b>		
Common shares (Note 8)	202,626	195,642
Additional paid-in capital	134	154
Retained earnings	19,485	15,240
Accumulated other comprehensive income	26,106	7,765
Total shareholders equity	248,351	218,801
Total liabilities and shareholders equity	1,303,475	1,302,594

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

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**MERCER INTERNATIONAL INC.**  
**CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS**  
**For Six Months Ended June 30, 2007 and 2006**  
**(Unaudited)**  
**(Euros in thousands, except for loss per share)**

	<b>2007</b>	<b>2006</b>
Revenues	346,134	292,262
Costs and expenses		
Operating costs	277,555	239,292
Operating depreciation and amortization	27,719	28,325
	40,860	24,645
General and administrative expenses	16,206	16,314
(Sale) purchase of emission allowances	(766)	(13,246)
Operating income from continuing operations	25,420	21,577
Other income (expense)		
Interest expense	(37,709)	(45,728)
Investment income	3,195	3,003
Unrealized foreign exchange gain on debt	2,603	12,173
Realized gain (loss) on derivative instruments (Note 5)	6,820	(5,219)
Unrealized gain on derivative instruments (Note 5)	17,852	90,724
Total other (expense) income	(7,239)	54,953
Income before income taxes and minority interest from continuing operations	18,181	76,530
Income tax provision	(13,705)	(42,920)
Income before minority interest from continuing operations	4,476	33,610
Minority interest	(43)	898
Net income from continuing operations	4,433	34,508
Net (loss) income from discontinued operations	(188)	501
Net income	4,245	35,009
Retained earnings (deficit), beginning of period	15,240	(47,970)
Retained earnings (deficit), end of period	19,485	(12,961)
Net income per share from continuing operations (Note 3)		
Basic	0.12	1.04

Diluted	0.12	0.85
Income per share		
Basic	0.12	1.06
Diluted	0.12	0.86

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

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**MERCER INTERNATIONAL INC.**  
**CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS**  
**For Three Months Ended June 30, 2007 and 2006**  
**(Unaudited)**  
**(Euros in thousands, except for loss per share)**

	<b>2007</b>	<b>2006</b>
Revenues	176,603	150,594
Costs and expenses		
Operating costs	142,808	124,385
Operating depreciation and amortization	13,990	14,637
	19,805	11,572
General and administrative expenses	8,901	8,597
(Sale) purchase of emission allowances	(39)	(7,608)
Operating income from continuing operations	10,943	10,583
Other income (expense)		
Interest expense	(17,641)	(22,914)
Investment income	1,584	1,263
Unrealized foreign exchange gain on debt	1,349	6,060
Realized loss on derivative instruments (Note 5)		(1,657)
Unrealized gain on derivative instruments (Note 5)	18,100	46,347
Total other income	3,392	29,099
Income before income taxes and minority interest from continuing operations	14,335	39,682
Income tax provision	(9,904)	(21,807)
Income before minority interest from continuing operations	4,431	17,875
Minority interest	(1,091)	449
Net income from continuing operations	3,340	18,324
Net (loss) income from discontinued operations	(181)	97
Net income	3,159	18,421
Retained earnings (deficit), beginning of period	16,326	(31,382)
Retained earnings (deficit), end of period	19,485	(12,961)
Net income per share from continuing operations (Note 3)		
Basic	0.09	0.55



Diluted	0.09	0.45
Income per share		
Basic	0.09	0.56
Diluted	0.09	0.45

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

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**MERCER INTERNATIONAL INC.**  
**CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME**  
**For Six Months Ended June 30, 2007 and 2006**  
**(Unaudited)**  
**(Euros in thousands)**

	<b>2007</b>	<b>2006</b>
Net income	4,245	35,009
Other comprehensive income:		
Foreign currency translation adjustment	18,254	5,360
Pension plan additional minimum liability		(17)
Unrealized gains on securities		
Unrealized holding gains arising during the period	87	690
Other comprehensive income	18,341	6,033
Total comprehensive income	22,586	41,042

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

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**MERCER INTERNATIONAL INC.**  
**CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME**  
**For Three Months Ended June 30, 2007 and 2006**  
**(Unaudited)**  
**(Euros in thousands)**

	<b>2007</b>	<b>2006</b>
Net income	3,159	18,421
Other comprehensive income:		
Foreign currency translation adjustment	16,350	8,345
Pension plan additional minimum liability		2
Unrealized gains on securities		
Unrealized holding gains arising during the period	85	569
Other comprehensive income	16,435	8,916
Total comprehensive income	19,594	27,337

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

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**MERCER INTERNATIONAL INC.**  
**CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS**  
**For Six Months Ended June 30, 2007 and 2006**  
**(Unaudited)**  
**(Euros in thousands)**

	<b>2007</b>	<b>2006</b>
Cash Flows (used in) from Operating Activities:		
Net income	4,245	35,009
Adjustments to reconcile net loss to cash flows from operating activities		
Unrealized gains on derivatives	(17,852)	(85,505)
Unrealized foreign exchange gain on debt	(2,603)	(12,173)
Operating depreciation and amortization	27,719	28,944
Non-operating amortization	128	138
Minority interest	43	(898)
Deferred income taxes	12,972	42,567
Stock compensation expense	196	207
Pension and other post-retirement expense	955	871
Other	924	(979)
Changes in current assets and liabilities		
Receivables	(26,721)	(13,486)
Inventories	(29,670)	10,670
Accounts payable and accrued expenses	15,129	(3,347)
Other	1,280	(252)
Net cash (used in) from operating activities	(13,255)	1,766
Cash Flows from (used in) Investing Activities:		
Cash restricted	12,000	(40,817)
Purchase of property, plant and equipment	(10,537)	(15,439)
Proceeds on sale of property, plant and equipment	527	526
Notes receivable	4,731	
Pension and other post-retirement benefit funding	(833)	(908)
Net cash from (used in) investing activities	5,888	(56,638)
Cash Flows (used in) from Financing Activities:		
Decrease in construction costs payable		(212)
Proceeds from borrowings of notes payable and debt		48,634
Repayment of notes payable and debt	(13,453)	(375)
Repayment of capital lease obligations	(2,576)	(2,431)
Issuance of shares of common stock	305	69
Net cash (used in) from financing activities	(15,724)	45,685
Effect of exchange rate changes on cash and cash equivalents	2,171	(1,281)

Net decrease in cash and cash equivalents	(20,920)	(10,468)
Cash and cash equivalents, beginning of period <sup>(1)</sup>	69,804	83,547
Cash and cash equivalents, end of period <sup>(2)</sup>	48,884	73,079
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	17,624	42,309
Income taxes	615	1,128
Supplemental schedule of non-cash investing and financing activities:		
Acquisition of production and other equipment under capital lease obligations	2,215	2,123
Common shares issued in satisfaction of floating rate note	6,728	

(1) Includes amounts related to discontinued operations of: 2007 437, 2006 722 (Note 10)

(2) Includes amounts related to discontinued operations of: 2007 582, 2006 751 (Note 10)

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

**MERCER INTERNATIONAL INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**FOR SIX MONTHS ENDED JUNE 30, 2007**

**(Unaudited)**

**(Euros in thousands, except for shares and per share data)**

**Note 1. Basis of Presentation**

*Basis of Presentation*

The interim period consolidated financial statements contained herein include the accounts of Mercer International Inc. ( Mercer Inc. ) and its wholly-owned and majority-owned subsidiaries (collectively, the Company ). The Company s shares of common stock are quoted and listed for trading on the NASDAQ National Market and the Toronto Stock Exchange, respectively.

The interim period consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (the SEC ). The year-end condensed balance sheet data was derived from audited financial statements, but certain information and footnote disclosure normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such SEC rules and regulations. The interim period consolidated financial statements should be read together with the audited consolidated financial statements and accompanying notes included in the Company s latest annual report on Form 10-K for the fiscal year ended December 31, 2006. In the opinion of the Company, the unaudited consolidated financial statements contained herein contain all adjustments necessary to present a fair statement of the results of the interim periods presented. The results for the periods presented herein may not be indicative of the results for the entire year.

*New Accounting Standards*

In February 2007, the FASB issued FASB Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( FAS 159 ). FAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value, with the objective of improving financial reporting by mitigating volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The provisions of FAS 159 are effective for the Company s year ending December 31, 2008. The Company is currently evaluating the impact that the adoption of this statement will have on the Company s consolidated financial position, results of operations and disclosures.

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**MERCER INTERNATIONAL INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**FOR SIX MONTHS ENDED JUNE 30, 2007**

(Unaudited)

(Euros in thousands, except for shares and per share data)

**Note 2. Stock-Based Compensation**

The Company adopted Statement of Financial Accounting Standards (SFAS) No. 123R, *Share-Based Payment*, on January 1, 2006. This statement requires the Company to recognize the cost of employee services received in exchange for the Company's equity instruments. Under SFAS No. 123R, the Company is required to record compensation expense over an award's vesting period based on the award's fair value at the date of grant. The Company has elected to adopt SFAS No. 123R on a modified prospective basis.

*Stock Options*

The Company has a non-qualified stock option plan which provides for options to be granted to officers and employees to acquire a maximum of 3,600,000 common shares including options for 130,000 shares to directors who are not officers or employees. During 2004, the Company adopted a stock incentive plan which provides for options, stock appreciation rights and restricted shares to be awarded to employees and outside directors to a maximum of 1,000,000 common shares.

Following is a summary of the status of options outstanding at June 30, 2007:

Exercise Price Range (In U.S. Dollars)	Outstanding Options			Exercisable Options		
	Number	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise price (In U.S. Dollars)	Number	Weighted Average Exercise Price (In U.S. Dollars)	
\$5.65 - 6.375	830,000	3.00	\$ 6.29	830,000	\$ 6.29	
8.50	135,000		8.50	135,000	8.50	
7.30	30,000	8.00	7.30	20,000	7.30	
7.92	68,334	8.25	7.92	40,000	7.92	

During the six-month period ended June 30, 2007, 30,000 options were exercised at an exercise price of \$6.375 and 26,666 options were exercised at an exercise price of \$7.92 for cash proceeds of \$402,435. 5,000 options were cancelled during the period. The average intrinsic value of the options exercised was \$4.58 per option. During the six-month period ended June 30, 2006, no options were exercised or cancelled.

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**MERCER INTERNATIONAL INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**FOR SIX MONTHS ENDED JUNE 30, 2007**

(Unaudited)

(Euros in thousands, except for shares and per share data)

**Note 2. Stock-Based Compensation (cont d)**

*Restricted Stock*

The fair value of restricted stock is determined based upon the number of shares granted and the quoted price of the Company's stock on the date of grant. Restricted stock generally vests over two years. Expense is recognized on a straight-line basis over the vesting period. Expense recognized for the six months ended June 30, 2007 and 2006 was 143 and 207, respectively.

As at June 30, 2007, the total remaining unrecognized compensation cost related to restricted stock amounted to 100, which will be amortized over their remaining vesting period.

During the six month period ended June 30, 2007, there were restricted stock awards granted of an aggregate of Nil (2006 10,000) of our common shares to independent directors and officers of the Company and Nil (2006 Nil) restricted stock awards were cancelled.

As at June 30, 2007, the total number of restricted stock awards outstanding was 190,686.

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**MERCER INTERNATIONAL INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**FOR SIX MONTHS ENDED JUNE 30, 2007**

(Unaudited)

(Euros in thousands, except for shares and per share data)

**Note 3. Income Per Share**

	Six Months Ended		Three Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
Net income from continuing operations	4,433	34,508	3,341	18,324
Interest on convertible notes, net of tax		2,767		1,441
Net income from continuing operations diluted	4,433	37,275	3,341	19,765
Net income from continuing operations per share:				
Basic	0.12	1.04	0.09	0.55
Diluted	0.12	0.85	0.09	0.45
Net income from continuing operations	4,433	34,508	3,341	18,324
Net (loss) income from discontinued operations	(188)	501	(181)	97
Net income Basic	4,245	35,009	3,160	18,421
Interest on convertible notes, net of tax		2,767		1,441
Net income Diluted	4,245	37,776	3,160	19,862
Net income per share:				
Basic	0.12	1.06	0.09	0.56
Diluted	0.12	0.86	0.09	0.45
Weighted average number of common shares outstanding:				
Basic	35,873,800	33,169,637	36,256,472	33,170,129
Effect of dilutive shares:				
Stock options and awards	465,146	274,686	437,715	292,002
Convertible notes	9,428,022	10,645,161	9,428,022	10,645,161
Diluted	45,766,968	44,089,484	46,122,209	44,107,292

The calculation of diluted income per share does not assume the exercise of stock options and awards or the conversion of convertible notes when their effect would be anti-dilutive on earnings per share. Convertible notes excluded from the calculation of diluted income per share because they are anti-dilutive represented 9,428,022 and Nil for the six months ended June 30, 2007 and 2006, respectively.

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**MERCER INTERNATIONAL INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**FOR SIX MONTHS ENDED JUNE 30, 2007**

(Unaudited)

(Euros in thousands, except for shares and per share data)

**Note 4. Inventories**

	<b>June 30, 2007</b>	<b>December 31, 2006</b>
Raw materials	66,886	38,905
Work in process and finished goods	28,005	23,952
	94,891	62,857

**Note 5 . Derivatives Transactions**

	<b>Six Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
Realized net gain (loss) on derivative financial instruments	6,820	(5,219)
Unrealized net gain on interest rate derivatives	23,786	36,326
Unrealized net (loss) gain on foreign exchange derivatives	(5,934)	54,398
Unrealized net gain on derivative financial instruments	17,852	90,724

	<b>Three Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
Realized net loss on derivative financial instruments		(1,657)
Unrealized net gain on interest rate derivatives	18,100	12,820
Unrealized net gain on foreign exchange derivatives		33,527
Unrealized net gain on derivative financial instruments	18,100	46,347

**MERCER INTERNATIONAL INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**FOR SIX MONTHS ENDED JUNE 30, 2007**

(Unaudited)

(Euros in thousands, except for shares and per share data)

**Note 6. Pension and Other Post-Retirement Benefit Obligations**

Included in pension and other post-retirement benefit obligations are amounts related to the Company's Celgar and German pulp mills.

The largest component of this obligation is with respect to the Celgar mill which maintains defined benefit pension plans and post-retirement benefits plans for certain employees. Pension benefits are based on employees' earnings and years of service. The pension plans are funded by contributions from the Company based on actuarial estimates and statutory requirements. Pension contributions for the six month periods ended June 30, 2007 and June 30, 2006 totaled 833 and 908, respectively.

	<b>Six Months Ended June 30,</b>			
	<b>2007</b>		<b>2006</b>	
	<b>Pension Benefits</b>	<b>Post-Retirement Benefits</b>	<b>Pension Benefits</b>	<b>Post-Retirement Benefits</b>
Service cost	410	230	448	227
Interest cost	666	362	706	382
Expected return on plan assets	(815)		(786)	
Recognized net loss		31		50
Net periodic benefit cost	261	623	368	659

	<b>Three Months Ended June 30,</b>			
	<b>2007</b>		<b>2006</b>	
	<b>Pension Benefits</b>	<b>Post-Retirement Benefits</b>	<b>Pension Benefits</b>	<b>Post-Retirement Benefits</b>
Service cost	209	117	222	112
Interest cost	339	184	350	190
Expected return on plan assets	(415)		(389)	
Recognized net loss		16		25
Net periodic benefit cost	133	317	183	327

The Company anticipates that it will make contributions to the pension plan of approximately 1,418 in 2007.

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**MERCER INTERNATIONAL INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**FOR SIX MONTHS ENDED JUNE 30, 2007**

(Unaudited)

(Euros in thousands, except for shares and per share data)

**Note 7. Income Taxes**

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109* ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*, and prescribes a recognition threshold and measurement attributes for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Under FIN 48, the impact of an uncertain income tax position on the income tax return must be recognized at the largest amount that is more likely than not to be sustained upon audit by the relevant taxing authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. Additionally, FIN 48 provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006.

The Company adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, the Company recognized no adjustment in the liability for unrecognized tax benefits.

As at the adoption date of January 1, 2007, the Company had approximately 18.6 million of total gross unrecognized tax benefits, substantially all of which would affect our effective tax rate if recognized.

The Company recognizes interest and penalties related to unrecognized tax benefits in income tax expense. During the year ended December 31, 2006, the Company recognized approximately Nil in penalties and interest. The Company had Nil for the payment of interest and penalties accrued at December 31, 2006. Upon adoption of FIN 48 on January 1, 2007, the Company had no change in its accrual for interest and penalties from Nil.

The Company and/or one or more of its subsidiaries file income tax returns in the United States, Germany and Canada. The Company is generally not subject to U.S., German or Canadian income tax examinations for tax years before 2003, 2001 and 2004, respectively.

**Note 8. Common Shares**

At June 30, 2007, the Company had outstanding 36,256,472 common shares with a par value of \$1.00 per share (June 30, 2006 33,170,129 shares).

On March 30, 2007, under the terms of a note payable to a third party, the Company at its sole option satisfied the principal amount of the note of 6,728 by issuing 742,185 common shares of the Company. The value of the shares paid was determined based on the 20-day trading day average closing price for the Company's shares which was \$12.09. The accrued interest outstanding on the note of 115 was paid on this date.

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**MERCER INTERNATIONAL INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**FOR SIX MONTHS ENDED JUNE 30, 2007**

(Unaudited)

(Euros in thousands, except for shares and per share data)

**Note 9. Restricted Group Supplemental Disclosure**

The terms of the indenture governing our 9.25% senior unsecured notes requires that we provide the results of operations and financial condition of Mercer International Inc. and our restricted subsidiaries under the indenture, collectively referred to as the Restricted Group. As at and during the six months ended June 30, 2007 and 2006, the Restricted Group was comprised of Mercer International Inc., certain holding subsidiaries and our Rosenthal and Celgar mills. The Restricted Group excludes the Stendal mill and up to December 31, 2006 the discontinued paper operations.

**Combined Condensed Balance Sheet**

	June 30, 2007			
	Restricted Group	Unrestricted Subsidiary	Eliminations	Consolidated Group
<b>ASSETS</b>				
Current assets				
Cash and cash equivalents	40,027	8,275		48,302
Receivables	50,159	54,335		104,494
Note receivable, current portion	617	5,217		5,834
Inventories	57,306	37,585		94,891
Prepaid expenses and other	2,445	3,017		5,462
Current assets from discontinued operations	1,104			1,104
Total current assets	151,658	108,429		260,087
Cash restricted		45,000		45,000
Property, plant and equipment	397,577	571,253		968,830
Other	6,382			6,382
Deferred income tax	11,715	6,955		18,670
Due from unrestricted group	56,540		(56,540)	
Note receivable, less current portion	4,506			4,506
Total assets	628,378	731,637	(56,540)	1,303,475
<b>LIABILITIES</b>				
Current				
Accounts payable and accrued expenses	52,366	48,604		100,970
Debt, current portion		33,364		33,364
Current liabilities from discontinued operations	651			651
Total current liabilities	53,017	81,968		134,985
Debt, less current portion	291,556	557,434		848,990
Due to restricted group		56,540	(56,540)	
Unrealized derivative loss		17,570		17,570
Capital leases	4,520	1,937		6,457
Deferred income tax	4,125	20,440		24,565

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Other long-term liabilities	22,544	13		22,557
Total liabilities	375,762	735,902	(56,540)	1,055,124
<b>SHAREHOLDERS EQUITY</b>				
Total shareholders equity (deficit)	252,616	(4,265)		248,351
Total liabilities and shareholders equity	628,378	731,637	(56,540)	1,303,475

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**MERCER INTERNATIONAL INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**FOR SIX MONTHS ENDED JUNE 30, 2007**

(Unaudited)

(Euros in thousands, except for shares and per share data)

**Note 9. Restricted Group Supplemental Disclosure (cont d)**

**Combined Condensed Balance Sheet**

	<b>December 31, 2006</b>			
	<b>Restricted Group</b>	<b>Unrestricted Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated Group</b>
<b>ASSETS</b>				
Current				
Cash and cash equivalents	39,078	30,289		69,367
Receivables	38,662	36,360		75,022
Note receivable, current portion	620	7,178		7,798
Inventories	41,087	21,770		62,857
Prepaid expenses and other	2,352	2,310		4,662
Current assets of discontinued operations		2,094		2,094
Total current assets	121,799	100,001		221,800
Cash restricted		57,000		57,000
Property, plant and equipment	408,957	563,186		972,143
Other	8,155	4,763		12,918
Deferred income tax	14,316	15,673		29,989
Due from unrestricted group	51,265		(51,265)	
Note receivable, less current portion	5,023	3,721		8,744
Total assets	609,515	744,344	(51,265)	1,302,594
<b>LIABILITIES</b>				
Current				
Accounts payable and accrued expenses	46,838	37,335		84,173
Debt, current portion		33,903		33,903
Current liabilities from discontinued operations		1,926		1,926
Total current liabilities	46,838	73,164		120,002
Debt, less current portion	293,781	580,147		873,928
Due to restricted group		51,265	(51,265)	
Unrealized derivative loss		41,355		41,355
Capital leases	2,720	3,482		6,202
Deferred income tax	2,832	20,079		22,911
Other long-term liabilities	19,395			19,395
Total liabilities	365,566	769,492	(51,265)	1,083,793
<b>SHAREHOLDERS EQUITY</b>				
Total shareholders equity (deficit)	243,949	(25,148)		218,801



Total liabilities and shareholders equity	609,515	744,344	(51,265)	1,302,594
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**MERCER INTERNATIONAL INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**FOR SIX MONTHS ENDED JUNE 30, 2007**

(Unaudited)

(Euros in thousands, except for shares and per share data)

**Note 9. Restricted Group Supplemental Disclosure (cont d)**

**Combined Condensed Statement of Operations**

	<b>Six Months Ended June 30, 2007</b>			
	<b>Restricted Group</b>	<b>Unrestricted Subsidiary</b>	<b>Eliminations</b>	<b>Consolidated Group</b>
Revenues	204,240	141,894		346,134
Operating costs	161,829	115,726		277,555
Operating depreciation and amortization	13,661	14,058		27,719
General and administrative expenses	10,623	5,583		16,206
(Sale) purchase of emission allowances	(268)	(498)		(766)
	185,845	134,869		320,714
Operating income from continuing operations	18,395	7,025		25,420
Other income (expense)				
Interest expense	(14,418)	(25,132)	1,841	(37,709)
Investment income	2,440	2,596	(1,841)	3,195
Unrealized foreign exchange gain on debt	2,263	340		2,603
Derivative financial instruments, net		24,672		24,672
Total other (expense) income	(9,715)	2,476		(7,239)
Income before income taxes and minority interest from continuing operations	8,680	9,501		18,181
Income tax provision	(4,150)	(9,555)		(13,705)
Income (loss) before minority interest from continuing operations	4,530	(54)		4,476
Minority interest		(43)		(43)
Net income (loss) from continuing operations	4,530	(97)		4,433
Net loss from discontinued operations	(188)			(188)
Net income (loss)	4,342	(97)		4,245

	<b>Six Months Ended June 30, 2006</b>			
	<b>Restricted Group</b>	<b>Unrestricted Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated Group</b>
Revenues	169,752	122,510		292,262

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Operating costs	148,388	90,904		239,292
Operating depreciation and amortization	14,197	14,128		28,325
General and administrative expenses	10,375	5,939		16,314
(Sale) purchase of emission allowances	(3,651)	(9,595)		(13,246)
	169,309	101,376		270,685
Operating income from continuing operations	443	21,134		21,577
Other income (expense)				
Interest expense	(16,442)	(31,046)	1,760	(45,728)
Investment income	2,119	2,644	(1,760)	3,003
Unrealized foreign exchange gain on debt	12,173			12,173
Derivative financial instruments, net		85,505		85,505
Total other income (expense)	(2,150)	57,103		54,953
Income (loss) before income taxes and minority interest from continuing operations	(1,707)	78,237		76,530
Income tax provision	(6,905)	(36,015)		(42,920)
Income (loss) before minority interest from continuing operations	(8,612)	42,222		33,610
Minority interest		898		898
Net income (loss) from continuing operations	(8,612)	43,120		34,508
Net income from discontinued operations		501		501
Net income (loss)	(8,612)	43,621		35,009

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**MERCER INTERNATIONAL INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**FOR SIX MONTHS ENDED JUNE 30, 2007**

(Unaudited)

(Euros in thousands, except for shares and per share data)

**Note 9. Restricted Group Supplemental Disclosure (cont d)**

**Combined Condensed Statement of Operations**

	<b>Three Months Ended June 30, 2007</b>			<b>Consolidated Group</b>
	<b>Restricted Group</b>	<b>Unrestricted Subsidiary</b>	<b>Eliminations</b>	
Revenues	104,307	72,296		176,603
Operating costs	85,271	57,537		142,808
Operating depreciation and amortization	6,975	7,015		13,990
General and administrative expenses	6,264	2,637		8,901
(Sale) purchase of emission allowances	(4)	(35)		(39)
	98,506	67,154		165,660
Operating income from continuing operations	5,801	5,142		10,943
Other income (expense)				
Interest expense	(6,961)	(11,606)	926	(17,641)
Investment income	1,136	1,374	(926)	1,584
Unrealized foreign exchange gain on debt	1,009	340		1,349
Derivative financial instruments, net		18,100		18,100
Total other income (expense)	(4,816)	8,208		3,392
Income before income taxes and minority interest from continuing operations	985	13,350		14,335
Income tax provision	(1,612)	(8,292)		(9,904)
Income (loss) before minority interest from continuing operations	(627)	5,058		4,431
Minority interest		(1,091)		(1,091)
Net income (loss) from continuing operations	(627)	3,967		3,340
Net loss from discontinued operations	(181)			(181)
Net income (loss)	(808)	3,967		3,159

	<b>Three Months Ended June 30, 2006</b>			<b>Consolidated Group</b>
	<b>Restricted Group</b>	<b>Unrestricted Subsidiaries</b>	<b>Eliminations</b>	
Revenues	88,741	61,853		150,594

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Operating costs	79,249	45,136		124,385
Operating depreciation and amortization	7,568	7,069		14,637
General and administrative expenses	5,415	3,182		8,597
(Sale) purchase of emission allowances	(1,884)	(5,724)		(7,608)
	90,348	49,663		140,011
Operating income from continuing operations	(1,607)	12,190		10,583
Other income (expense)				
Interest expense	(7,979)	(15,820)	885	(22,914)
Investment income (loss)	(142)	2,290	(885)	1,263
Unrealized foreign exchange gain on debt	6,060			6,060
Derivative financial instruments, net	79	44,611		44,690
Total other income (expense)	(1,982)	31,081		29,099
Income (loss) before income taxes and minority interest from continuing operations	(3,589)	43,271		39,682
Income tax provision	(3,872)	(17,935)		(21,807)
Income (loss) before minority interest from continuing operations	(7,461)	25,336		17,875
Minority interest		449		449
Net income (loss) from continuing operations	(7,461)	25,785		18,324
Net income from discontinued operations		97		97
Net income (loss)	(7,461)	25,882		18,421

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**MERCER INTERNATIONAL INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**FOR SIX MONTHS ENDED JUNE 30, 2007**

(Unaudited)

(Euros in thousands, except for shares and per share data)

**Note 10. Discontinued Operations**

In August 2006, the Company reorganized and divested its equity interests in certain paper production assets for aggregate consideration of approximately 5.0 million of indebtedness, in the form of a secured note, and 5.0 million in cash.

On November 16, 2006, the Company divested its last remaining paper production assets to focus exclusively on the manufacture and sale of pulp.

Accordingly, the information related to the paper production assets is presented as discontinued operations in the Company's consolidated condensed financial statements.

The carrying amounts of the major classes of related assets and liabilities were as follows:

	<b>June 30, 2007</b>	<b>December 31, 2006</b>
Assets		
Cash and cash equivalents	582	437
Receivables	522	1,657
Liabilities		
Accounts payable and accrued expenses	651	1,926

Condensed earnings from discontinued operations are as follows:

	<b>Six Months Ended June 30,</b>		<b>Three Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Revenues	110	33,507	35	16,111
Operating (loss) income from discontinued operations	(136)	802	(155)	291
Total other expenses	52	301	26	194
Net (loss) income from discontinued operations	(188)	501	(181)	97
Earnings (loss) per common share from discontinued operations				
basic		0.02		0.01
Earnings (loss) per common share from discontinued operations				
diluted		0.01		

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**MERCER INTERNATIONAL INC.  
 NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS  
 FOR SIX MONTHS ENDED JUNE 30, 2007**

(Unaudited)

(Euros in thousands, except for shares and per share data)

**Note 10. Discontinued Operations (cont d)**

Condensed cash flows from discontinued operations are as follows:

	<b>Six Months Ended</b>	
	<b>June 30,</b>	
	<b>2007</b>	<b>2006</b>
Cash flows from (used in) operating activities	145	(279)
Cash flows used in investing activities		(567)
Cash flows from financing activities		825
Cash flows from (used in) discontinued operations	145	(21)

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

In this document: (i) unless the context otherwise requires, references to we, our, us, the Company or Mercer mean Mercer International Inc. and its subsidiaries; (ii) references to Mercer Inc. mean the Company excluding its subsidiaries; (iii) information is provided as of June 30, 2007, unless otherwise stated; (iv) all references to monetary amounts are to Euros, the lawful currency adopted by most members of the European Union, unless otherwise stated; (v) refers to Euros, \$ refers to U.S. dollars and C\$ refers to Canadian dollars; and (vi) ADMTs refers to air-dried metric tonnes.

We operate three NBSK pulp mills through our wholly owned subsidiaries, Rosenthal and Celgar, and our 70.6% owned subsidiary, Stendal, which have a consolidated annual production capacity of approximately 1.4 million ADMTs.

The following discussion and analysis of our results of operations and financial condition for the six and three months ended June 30, 2007 should be read in conjunction with our consolidated condensed financial statements and related notes included in this quarterly report, as well as our most recent annual report on Form 10-K for the fiscal year ended December 31, 2006 filed with the Securities and Exchange Commission (the SEC). The following Management's Discussion and Analysis of Financial Condition and Results of Operations reflects:

the disposition of our paper operations in 2006. In accordance with SFAS No. 144 Accounting for the Impairment or Disposal of Long-Lived Assets, the results of this business have been classified as discontinued operations; and

only our continuing operations except as otherwise expressly noted.

### Results of Operations

#### *Six Months Ended June 30, 2007 Compared to Six Months Ended June 30, 2006*

Selected production, sales and exchange rate data for the six months ended June 30, 2007 and 2006 is as follows:

	<b>Six Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
<b>Pulp production (ADMTs)</b>	673,606	626,210
<b>Pulp sales (ADMTs)</b>	666,151	666,223
<b>Revenues (in millions)</b>	346.1	292.3
NBSK list prices in Europe (\$/ADMT)	\$ 770	\$ 642
Average pulp price realizations ( /ADMT)	515	440
<b>Average Currency Exchange Rates</b>		
/ (\$)	0.7522	0.8131
C\$ / \$( <sup>1</sup> )	1.1349	1.1385
C\$ / ( <sup>2</sup> )	1.5082	1.3995

(1) Average Federal Reserve Bank of New York noon spot rate over the reporting period.

(2) Average Bank of Canada noon



spot rate over  
the reporting  
period.

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Revenues for the six months ended June 30, 2007 increased by approximately 18% to 346.1 million from 292.3 million in the comparative period of 2006, primarily due to higher pulp prices, partially offset by a weakening of the U.S. dollar versus the Euro. Pulp sales volume was relatively unchanged at 666,151 ADMTs in the first half of 2007 compared to 666,223 ADMTs in the comparative period of 2006.

List prices for NBSK pulp in Europe were approximately 570 (\$770) per ADMT in the first half of 2007 and approximately 522 (\$642) per ADMT in the first half of 2006.

Average pulp sales realizations increased to 515 per ADMT in the first half of 2007 from 440 per ADMT in the first half of 2006. Higher pulp prices were partially offset by foreign exchange changes in the period. The U.S. dollar was 8% weaker compared to the Euro from the comparative period of 2006.

Cost of sales and general, administrative and other expenses in the first half of 2007 increased to 320.7 million from 270.7 million in the comparative period of 2006, primarily as a result of increased fiber costs.

During the current period, we took an aggregate of 24 days scheduled maintenance and strategic capital downtime at our pulp mills, including 12 days at our Stendal mill and 12 days at our Celgar mill. During the scheduled downtime at Celgar, we implemented the final phase of our Blue Goose strategic capital project consisting of the dryer capacity expansion. These changes have begun to show improvements in production capacity and operational efficiencies. During the comparative period of 2006, our pulp mills took approximately 42 days maintenance and strategic capital expenditure downtime. In the third quarter of 2007, we have scheduled 9 days of downtime at our Rosenthal mill for maintenance.

Fiber costs increased by approximately 46% in the first half of 2007 versus the same period of 2006. In Germany, this resulted from lower availability because of low harvesting levels in 2006 and increased demand for wood residuals from renewable energy suppliers. Fiber costs at our Celgar mill increased primarily because of a weakening U.S. lumber market that has caused a sharp reduction in sawmill residual production. The fiber availability in Europe has begun to increase as a result of the approximately 60 million cubic meters of wind-felled timber caused by storms in January, particularly in the south of Germany near our Rosenthal mill. This, coupled with the recent strength of the European lumber market, has started to provide some price relief late in the second quarter and we expect further downward pressure on fiber prices for deliveries throughout the balance of the year.

As a result of continued weak markets and prices for the sale of emission allowances, our contribution to income from the such sale of emission allowances in the first half of 2007 was 0.8 million, compared to 13.2 million in the comparative period of 2006.

Operating depreciation and amortization in the first half of 2007 decreased marginally to 27.7 million from 28.3 million in the comparative period of 2006.

For the first half of 2007, operating income increased by approximately 18% to 25.4 million from 21.6 million in the first half of 2006, primarily due to higher pulp prices.

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Interest expense in the first half of 2007 decreased to 37.7 million from 45.7 million in the year ago period, primarily due to a lower level of borrowing from the Stendal facility and the settlement of the cross currency swaps in the first quarter of 2007.

Stendal entered into certain foreign currency derivatives to swap a portion of its long-term bank indebtedness from Euros to U.S. dollars in 2005 and certain currency forwards. In addition, Stendal previously entered into interest rate swaps to fix the interest rate on its outstanding bank indebtedness. Due to the weakening of the U.S. dollar versus the Euro and an increase in long-term interest rates, we recorded a gain of 24.7 million before minority interests on our outstanding derivatives at the end of the first half of 2007, including a realized gain of 6.8 million on the settlement of our currency swaps. In the comparative period of 2006, we recorded a net gain of 85.5 million on our derivatives which included a loss of 5.2 million from the settlement of currency forwards.

In the first half of 2007, minority interest, representing the minority shareholder's proportionate interest in the Stendal mill's losses for the period, was negligible, compared to 0.9 million in the first half of 2006.

We reported net income from continuing operations for the first half of 2007 of 4.4 million, or 0.12 per basic and diluted share, which included an aggregate net gain of 27.3 million on our outstanding derivatives and an unrealized foreign exchange gain on our long-term debt. In the first half of 2006, we reported net income from continuing operations of 34.5 million, or 1.04 per basic and 0.85 per diluted share, which reflected a net unrealized gain of 97.7 million on our outstanding derivatives and an unrealized non-cash foreign exchange gain on our long-term debt. We generated Operating EBITDA of 53.3 million and 49.9 million in the six months ended June 30, 2007 and 2006, respectively. Operating EBITDA is defined as operating income from continuing operations plus depreciation and amortization and non-recurring capital asset impairment charges.

Management uses Operating EBITDA as a benchmark measurement of its own operating results, and as a benchmark relative to its competitors. Management considers it to be a meaningful supplement to operating income as a performance measure primarily because depreciation expense and non-recurring capital asset impairment charges are not an actual cash cost, and depreciation expense varies widely from company to company in a manner that management considers largely independent of the underlying cost efficiency of their operating facilities. In addition, we believe Operating EBITDA is commonly used by securities analysts, investors and other interested parties to evaluate our financial performance.

Operating EBITDA does not reflect the impact of a number of items that affect our net income, including financing costs and the effect of derivative instruments. Operating EBITDA is not a measure of financial performance under GAAP, and should not be considered as an alternative to net income or income from operations as a measure of performance, nor as an alternative to net cash from operating activities as a measure of liquidity.

Operating EBITDA has significant limitations as an analytical tool, and should not be considered in isolation, or as a substitute for analysis of our results as reported under GAAP. Some of these limitations are that Operating EBITDA does not reflect: (i) our cash expenditures, or future requirements, for capital expenditures or contractual commitments; (ii) changes in, or cash

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requirements for, working capital needs; (iii) the significant interest expense, or the cash requirements necessary to service interest or principal payments, on our outstanding debt; (iv) minority interests on our Stendal NBSK pulp mill operations; (v) the impact of realized or marked to market changes in our derivative positions, which can be substantial; and (vi) the impact of impairment charges against our investments or assets. Because of these limitations, Operating EBITDA should only be considered as a supplemental performance measure and should not be considered as a measure of liquidity or cash available to us to invest in the growth of our business. See the Statement of Cash Flows set out in our consolidated condensed financial statements included herein. Because all companies do not calculate Operating EBITDA in the same manner, Operating EBITDA as calculated by us may differ from Operating EBITDA or EBITDA as calculated by other companies. We compensate for these limitations by using Operating EBITDA as a supplemental measure of our performance and relying primarily on our GAAP financial statements. The following table provides a reconciliation of net income from continuing operations to operating income from continuing operations and Operating EBITDA for the periods indicated:

	<b>Six Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(in thousands)</b>	
Net income from continuing operations	4,433	34,508
Minority interest	43	(898)
Income taxes	13,705	42,920
Interest expense	37,709	45,728
Investment income	(3,195)	(3,003)
Unrealized foreign exchange gain on debt	(24,672)	(12,173)
Derivative financial instruments, net gain	(2,603)	(85,505)
Operating income from continuing operations	25,420	21,577
Add: Depreciation and amortization	27,847	28,325
Operating EBITDA	53,267	49,902

***Three Months Ended June 30, 2007 Compared to Three Months Ended June 30, 2006***

Selected production, sales and exchange rate data for the three months ended June 30, 2007 and 2006 is as follows:

	<b>Three Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
<b>Pulp production (ADMTs)</b>	326,350	307,742
<b>Pulp sales (ADMTs)</b>	337,016	334,136
<b>Revenues (in millions)</b>	176.6	150.6
NBSK list prices in Europe (\$/ADMT)	\$ 783	\$ 665
Average pulp price realizations ( /ADMT)	518	453
<b>Average Currency Exchange Rates</b>		
/ (\$)	0.7416	0.7957
C\$ / \$( <sup>1</sup> )	1.0981	1.1224
C\$ / ( <sup>2</sup> )	1.4810	1.4104

(1) Average Federal Reserve Bank of New York noon spot rate over the reporting period.

(2) Average Bank of Canada noon spot rate over the reporting period.

Revenues for the three months ended June 30, 2007 increased by approximately 17% to 176.6 million from 150.6 million in the comparative quarter of 2006, primarily due to stronger pulp prices and higher sales volumes. A 7% weaker U.S. dollar versus the Euro eroded these gains

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significantly. Pulp sales volume increased to 337,016 ADMTs in the second quarter of 2007 from 334,136 ADMTs in the comparative quarter of 2006.

List prices for NBSK pulp in Europe were approximately 579 (\$783) per ADMT in the second quarter of 2007, approximately 578 (\$757) per ADMT in the first quarter of 2007 and approximately 529 (\$665) in the second quarter of 2006.

Average pulp sales realizations increased to 518 per ADMT in the second quarter of 2007 from 453 per ADMT in the second quarter of 2006, primarily as a result of higher pulp prices, partially offset by the weaker U.S. dollar.

Cost of sales and general, administrative and other expenses in the second quarter of 2007 increased to 165.7 million from 140.0 million in the comparative quarter of 2006, primarily as a result of increased fiber costs.

During the current quarter, we took an aggregate of 24 days scheduled downtime at our Stendal and Celgar mills.

During the downtime at our Celgar mill, we implemented the final phase of our strategic capital expenditure program.

During the comparative quarter of 2006, our pulp mills took approximately 30 days maintenance and strategic capital expenditure downtime.

During the second quarter, Rosenthal concluded a new labor contract with the union which represents the majority of its employees. The agreement contains provisions that lengthen the work week to standard industry practice and provides for a 3% wage increase over the next eighteen months. The new labor contract is set to expire at the end of 2008.

Fiber costs increased by approximately 39% in the second quarter of 2007 versus the same quarter of 2006. In Germany, this resulted from lower availability because of low harvesting levels in 2006 and increased demand for wood residuals from renewable energy suppliers. Fiber costs at our Celgar mill increased primarily because of a weakening U.S. lumber market that has caused a sharp reduction in sawmill residual production. The fiber availability in Europe has begun to increase as a result of the approximately 60 million cubic meters of wind-felled timber caused by storms in January, particularly in the south of Germany near our Rosenthal mill. This, coupled with the recent strength of the European lumber market, has started to provide some price relief late in the quarter and we expect further downward pressure on fiber prices for deliveries throughout the balance of the year.

As a result of continued weak markets and prices for the sale of emission allowances, our contribution to income from the sale of such emission allowances in the second quarter of 2007 was nil compared to 7.6 million in the comparative period of 2006.

Operating depreciation and amortization decreased moderately to 14.0 million from 14.6 million in the comparative quarter of 2006.

For the second quarter of 2007, operating income increased by approximately 3% to 10.9 million from 10.6 million in the second quarter of 2006. The increase was primarily due to higher pulp prices.

Interest expense in the second quarter of 2007 decreased to 17.6 million from 22.9 million in the year ago period, primarily due to a lower level of borrowing from the Stendal facility and the settlement of the cross currency swaps in the first quarter of 2007.

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Stendal entered into certain foreign currency derivatives to swap a portion of its long-term bank indebtedness from Euros to U.S. dollars in 2005 and certain currency forwards. In addition, Stendal previously entered into interest rate swaps to fix the interest rate on its outstanding bank indebtedness. Due to an increase in long-term interest rates, we recorded a non-cash gain of \$18.1 million before minority interests on our outstanding interest rate derivatives during the second quarter of 2007. In the comparative quarter of 2006, we recorded a net gain of \$44.7 million on our then outstanding currency and interest rate derivatives which included a loss of \$1.7 million from the settlement of currency forwards.

In the second quarter of 2007, minority interest, representing the minority shareholder's proportionate interest in the Stendal mill's income for the period, was \$1.1 million, compared to its \$0.4 million share of losses in the second quarter of 2006.

We reported net income from continuing operations for the second quarter of 2007 of \$3.3 million, or \$0.09 per basic and diluted share, which included an aggregate net gain of \$19.4 million on our outstanding derivatives and an unrealized foreign exchange gain on our long-term debt. In the second quarter of 2006, we reported net income from continuing operations of \$18.3 million, or \$0.55 per basic and \$0.45 per diluted share, which reflected a net gain of \$50.8 million on our outstanding derivatives and an unrealized non-cash foreign exchange gain on our long-term debt. We generated Operating EBITDA of \$25.0 million and \$25.2 million in the three months ended June 30, 2007 and 2006, respectively. Operating EBITDA has significant limitations as an analytical tool and should not be considered in isolation or as a substitute for analysis of our results as reported under GAAP. See the discussion of our results for the first half of 2007 for additional information relating to Operating EBITDA.

The following table provides a reconciliation of net income from continuing operations to operating income from continuing operations and Operating EBITDA for the periods indicated:

	<b>Three Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(in thousands)</b>	
Net income from continuing operations	3,340	18,324
Minority interest	1,091	(449)
Income taxes	9,904	21,807
Interest expense	17,641	22,914
Investment income	(1,584)	(1,263)
Unrealized foreign exchange gain on debt	(1,349)	(6,060)
Derivative financial instruments, net gain	(18,100)	(44,690)
Operating income from continuing operations	10,943	10,583
Add: Depreciation and amortization	14,055	14,637
Operating EBITDA	24,998	25,220

**Liquidity and Capital Resources**

The following table is a summary of selected financial information for the periods indicated:

	As at June 30, 2007	As at December 31, 2006
	(in thousands) (unaudited)	
<b>Financial Position</b>		
Cash and cash equivalents	48,302	69,367
Working capital <sup>(1)</sup>	124,649	101,630
Property, plant and equipment	968,830	972,143
Total assets <sup>(1)</sup>	1,302,371	1,300,500
Long-term liabilities	920,139	963,791
Shareholders' equity	248,351	218,801

(1) Excluding assets and liabilities of discontinued operations.

As at June 30, 2007, we had not drawn any amount under the 40.0 million Rosenthal revolving term credit facility and had drawn down approximately 12.5 million of the C\$40 million Celgar revolving credit facility.

We expect to meet our interest and debt service expenses and the working and maintenance capital requirements for our operations from cash flow from operations, cash on hand and the two revolving working capital facilities for the Rosenthal and Celgar mills.

We currently expect to meet the capital requirements for the Stendal mill, including working capital, interest and principal service expenses through cash on hand, cash flow from operations and the Stendal Loan Facility. Pursuant to such facility, Stendal established a restricted cash debt service reserve account, the target balance of which is the scheduled interest and principal payments for the ensuing year. Under such facility, Stendal is currently restricted from making certain payments, including paying dividends to us and its other minority shareholder as it does not meet prescribed financial performance ratios and the debt service reserve account balance requirements.

**Operating Activities**

Operating activities in the first half of 2007 used cash of 13.3 million, compared to providing cash of 1.8 million in the comparative period of 2006. An increase in receivables due primarily to higher sales used cash of 26.7 million in the first half of 2007, compared to an increase in receivables using cash of 13.5 million in the comparative period of 2006. An increase in inventories used cash of 29.7 million in the first half of 2007, most of which was due to a build up of fiber supply at our three mills. In 2006, a decrease in inventories provided cash of 10.7 million in the first half of 2006. An increase in accounts payable and accrued expenses provided cash of 15.1 million in the first half of 2007, compared to using cash of 3.3 million in the comparative period of 2006.

Working capital is subject to cyclical operating needs, the timing of collections and receivables and government grants and the payment of payables and expenses.

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***Investing Activities***

Investing activities in the six months ended June 30, 2007 provided cash of \$5.9 million, primarily due to a drawdown of funds in our debt service reserve account under the Stendal facility. The repayment of notes receivable provided cash of \$4.7 million, including \$3.9 million from a receivable from our discontinued operations. In the six months ended June 30, 2006 investing activities used cash of \$56.6 million primarily due to a drawdown under a tranche of the Stendal Loan Facility to increase the restricted cash in Stendal's debt service reserve account of \$40.8 million. Capital expenditures used cash of \$10.5 million in the first half of 2007 compared to using cash of \$15.4 million in the comparative period of 2006.

***Financing Activities***

Financing activities used cash of \$15.7 million in the six months ended June 30, 2007 primarily due to scheduled principal repayments of the Stendal facility in the first half of 2007. In the comparative period in 2006, financing activities provided cash of \$45.7 million primarily due to a draw down of \$42.0 million pursuant to the Stendal facility. We have no material commitments to acquire assets or operating businesses. We anticipate that there will be acquisitions of businesses or commitments to projects in the future. To achieve our long-term goals of expanding our asset and earnings base through the acquisition of interests in companies and assets in the pulp and paper and related businesses, and organically through high return capital expenditures at our operating facilities, we will require substantial capital resources. The required necessary resources for such long-term goals will be generated from cash flow from operations, cash on hand, the sale of securities and/or assets, and borrowing against our assets.

***Contractual Obligations and Commitments***

There were no material changes outside the ordinary course to any of our contractual obligations during the first half of 2007.

***Capital Resources***

In addition to our current credit facilities, we may seek to raise future funding in the debt markets if our indenture relating to our 9.25% senior notes permits, subject to compliance with the indenture. The indenture governing the senior notes provides that, in order for Mercer Inc. and its restricted subsidiaries (as defined in the indenture and which excludes the Stendal mill and, up to December 31, 2006, our discontinued operations) to enter into certain types of transactions, including the incurrence of additional indebtedness, the making of restricted payments and the completion of mergers and consolidations (other than, in each case, those specifically permitted by our senior note indenture), we must meet a minimum ratio of Indenture EBITDA to Fixed Charges as defined in the senior note indenture of 2.0 to 1.0 on a pro forma basis for the most recently ended four full fiscal quarters.

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### ***Convertible Notes***

We currently have outstanding \$67.3 million of subordinated convertible notes due October 2010, with interest payable semi-annually at 8.5%. The notes are convertible by the holder at any time into our common shares at \$7.75 per share. We may redeem for cash all or a portion of the notes at any time on or after October 15, 2008 at 100% of the principal amount of the notes plus accrued and unpaid interest.

### **Foreign Currency**

Our reporting currency is the Euro as the majority of our business transactions are denominated in Euros. However, we hold certain assets and liabilities in U.S. dollars, Canadian dollars and, to a minor extent, Swiss francs.

Accordingly, our consolidated financial results are subject to foreign currency exchange rate fluctuations.

We translate foreign denominated assets and liabilities into Euros at the rate of exchange on the balance sheet date.

Unrealized gains or losses from these translations are recorded in our consolidated statement of comprehensive income and impact on shareholders' equity on the balance sheet but do not affect our net earnings.

In the six months ended June 30, 2007, we reported a net 18.3 million foreign exchange translation gain and, as a result, the cumulative foreign exchange translation gain reported within comprehensive income increased to 30.1 million at June 30, 2007 from 11.9 million at December 31, 2006.

Based upon the exchange rate at June 30, 2007, the U.S. dollar decreased by approximately 6% in value against the Euro since June 30, 2006. See Quantitative and Qualitative Disclosures about Market Risk .

### **Results of Operations of the Restricted Group Under Our Senior Note Indenture**

The indenture governing our 9.25% senior notes requires that we also provide a discussion in annual and quarterly reports we file with the SEC under Management's Discussion and Analysis of Financial Condition and Results of Operations of the results of operations and financial condition of Mercer Inc. and our restricted subsidiaries under the indenture, referred to as the Restricted Group . The Restricted Group is comprised of Mercer Inc., certain holding subsidiaries, Rosenthal and the Celgar mill. The Restricted Group excludes our Stendal mill and, up to December 31, 2006, our discontinued operations.

The following is a discussion of the results of operations and financial condition of the Restricted Group. For further information regarding the Restricted Group including, without limitation, a reconciliation to our consolidated results of operations, see Note 9 of our quarterly consolidated condensed financial statements included herein.

### ***Restricted Group Results Six Months Ended June 30, 2007 Compared to Six Months Ended June 30, 2006***

Total revenues for the Restricted Group for the six months ended June 30, 2007 increased to 204.2 million from 169.8 million in the comparative period of 2006, primarily because of higher pulp sales from the Celgar mill and higher prices. Pulp sales realizations for the Restricted Group were 525 per ADMT on average in the six months ended June 30, 2007 and 444 per ADMT in the comparative period of 2006. The increase in NBSK pulp prices was partially offset by the strength of the Canadian dollar and Euro versus the U.S. dollar during the current period. Costs of sales and general, administrative and other expenses for the Restricted Group in the six months ended June 30, 2007 increased to 185.8 million from 169.3 million in the comparative period of 2006, primarily as a result of increased fiber costs.

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During the current period, we took an aggregate of 12 days scheduled downtime at our Celgar mill. During the comparative period of 2006, our Rosenthal and Celgar mills took approximately 33 days of maintenance and strategic capital expenditure downtime, during which Rosenthal completed the installation of a new brownstock washer. In the third quarter of 2007, we have scheduled 9 days of downtime at our Rosenthal mill for maintenance.

During the scheduled downtime at Celgar, we implemented the final phase of our Blue Goose capital project consisting of the dryer capacity expansion. These changes have begun to show improvements in production capacity and operational efficiencies.

As a result of continued weak markets and prices for the sale of emission allowances, our contribution to income from the sale of such emission allowances by our Rosenthal pulp mill in the first half of 2007 was 0.3 million, compared to 3.7 million in the comparative period of 2006.

Fiber costs of the Restricted Group increased by approximately 55% in the first six months of 2007 versus the same period of 2006. This resulted from lower availability because of low harvesting levels in 2006 and increased demand for wood residuals from renewable energy suppliers. Fiber costs at our Celgar mill increased primarily because of a weakening U.S. lumber market that has caused a sharp reduction in sawmill residual production. The fiber availability in Europe has begun to increase as a result of approximately 60 million cubic meters of wind-felled timber caused by storms in January. This, coupled with an improving European lumber market, has started to provide some price relief and we expect further downward pressure on fiber prices for deliveries throughout the balance of the year.

Operating depreciation and amortization for the Restricted Group increased marginally to 13.7 million in the current period from 14.2 million in the comparative period of 2006.

In the first half of 2007, the Restricted Group reported operating income from continuing operations of 18.4 million, compared to 0.4 million in the first half of 2006, primarily as a result of improving pulp markets. Interest expense for the Restricted Group in the six months ended June 30, 2007 decreased to 14.4 million from 16.4 million in the year ago period.

In the current period of 2007, the Restricted Group recorded a foreign exchange gain on debt of 2.3 million, compared to a gain of 12.2 million in the comparative period of 2006.

For the six months ended June 30, 2007, the Restricted Group reported net income from continuing operations of 4.5 million, compared to a loss of 8.6 million in the first six months of 2006, primarily as a result of higher pulp prices and improved results at our Celgar mill.

The Restricted Group generated Operating EBITDA of 32.1 million and 14.6 million in the six months ended June 30, 2007 and 2006, respectively. Operating EBITDA is defined as operating income (loss) from continuing operations plus depreciation and amortization and non-recurring capital asset impairment charges. Operating EBITDA for the Restricted Group is calculated by adding depreciation and amortization to the operating income from continuing operations of 18.4 million and 0.4 million for the six months ended June 30, 2007 and 2006, respectively.

Operating EBITDA has significant limitations as an analytical tool, and should not be considered in isolation, or as a substitute for analysis of our results as reported under GAAP. See the

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discussion of Mercer's results for the six months ended June 30, 2007 for additional information relating to such limitations and Operating EBITDA.

The following table provides a reconciliation of net income (loss) from continuing operations to operating income from continuing operations and Operating EBITDA for the Restricted Group for the periods indicated:

	<b>Six Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(in thousands)</b>	
<b>Restricted Group</b>		
Net income (loss) from continuing operations <sup>(1)</sup>	4,530	(8,612)
Income taxes	4,150	6,905
Interest expense	14,418	16,442
Investment and other income	(2,440)	(2,119)
Unrealized foreign exchange gain on debt	(2,263)	(12,173)
Operating income from continuing operations	18,395	443
Add: Depreciation and amortization	13,661	14,197
Operating EBITDA <sup>(1)</sup>	32,056	14,640

(1) See Note 9 of the consolidated condensed financial statements included elsewhere herein for a reconciliation to our consolidated results.

***Restricted Group Results Three Months Ended June 30, 2007 Compared to Three Months Ended June 30, 2006***

Total revenues for the Restricted Group for the three months ended June 30, 2007 increased to \$104.3 million from \$88.7 million in the comparative quarter of 2006, primarily because of higher pulp sales from the Celgar mill and higher prices. Pulp sales realizations for the Restricted Group were \$528 per ADMT on average in the three months ended June 30, 2007 and \$459 per ADMT in the comparative quarter of 2006. The increase in NBSK pulp prices was partially offset by the strength of the Canadian dollar and Euro versus the U.S. dollar during the current period. Costs of sales and general, administrative and other expenses for the Restricted Group in the three months ended June 30, 2007 increased to \$98.5 million from \$90.3 million in the comparative quarter of 2006, primarily as a result of increased fiber costs.

During the current period, we took an aggregate of 12 days scheduled downtime at our Celgar mill. During the comparative period of 2006, our Rosenthal and Celgar mills took approximately 24 days of maintenance and strategic capital expenditure downtime, during which Rosenthal completed the installation of a new brownstock washer. In the third quarter of 2007, we have scheduled 9 days of downtime at our Rosenthal mill for maintenance.

During the scheduled downtime at Celgar, we implemented the final phase of our Blue Goose capital project consisting of the dryer capacity expansion. These changes have begun to show improvements in production capacity and operational efficiencies.

As a result of continued weak markets and prices for the sale of emission allowances, our contribution to income from the sale of such emission allowances by our Rosenthal pulp mill in the second quarter of 2007 was nil, compared to 1.9 million in the comparative period of 2006.

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Fiber costs of the Restricted Group increased by approximately 53% in the second quarter of 2007 versus the same period of 2006. This resulted from lower availability because of low harvesting levels in 2006 and increased demand for wood residuals from renewable energy suppliers. Fiber costs at our Celgar mill increased primarily because of a weakening U.S. lumber market that has caused a sharp reduction in sawmill residual production. The fiber availability in Europe has begun to increase as a result of approximately 60 million cubic meters of wind-felled timber caused by storms in January. This, coupled with an improving European lumber market, has started to provide some price relief and we expect further downward pressure on fiber prices for deliveries throughout the balance of the year.

Operating depreciation and amortization for the Restricted Group decreased marginally to 7.0 million in the current quarter from 7.6 million in the comparative quarter of 2006.

In the second quarter of 2007, the Restricted Group reported operating income from continuing operations of

5.8 million, compared to an operating loss from continuing operations of 1.6 million in the second quarter of 2006, primarily as a result of improving pulp markets and improved operating results at our Celgar mill. Interest expense for the Restricted Group in the three months ended June 30, 2007 decreased to 7.0 million from 8.0 million in the year ago period.

In the current quarter of 2007, the Restricted Group recorded a foreign exchange gain on debt of 1.0 million, compared to 6.1 million in the comparative quarter of 2006.

For the three months ended June 30, 2007, the Restricted Group reported net loss from continuing operations of

0.6 million, compared to a loss of 7.5 million in the three months ended June 30, 2006, primarily as a result of higher pulp prices and improved results at our Celgar mill.

The Restricted Group generated Operating EBITDA of 12.8 million and 6.0 million in the three months ended June 30, 2007 and 2006, respectively. Operating EBITDA is defined as operating income (loss) from continuing operations plus depreciation and amortization and non-recurring capital asset impairment charges. Operating EBITDA for the Restricted Group is calculated by adding depreciation and amortization to the operating income (loss) from continuing operations of 5.8 million and (1.6) million for the three months ended June 30, 2007 and 2006, respectively.

Operating EBITDA has significant limitations as an analytical tool, and should not be considered in isolation, or as a substitute for analysis of our results as reported under GAAP. See the discussion of Mercer's results for the six months ended June 30, 2007 for additional information relating to such limitations and Operating EBITDA.

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The following table provides a reconciliation of net loss from continuing operations to operating income (loss) from continuing operations and Operating EBITDA for the Restricted Group for the periods indicated:

	<b>Three Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(in thousands)</b>	
<b>Restricted Group</b>		
Net loss from continuing operations <sup>(1)</sup>	(627)	(7,461)
Income taxes	1,612	3,872
Interest expense	6,961	7,979
Investment and other (income) expense	(1,136)	142
Unrealized foreign exchange gain on debt	(1,009)	(6,060)
Derivative financial instruments, net loss		(79)
Operating income (loss) from continuing operations	5,801	(1,607)
Add: Depreciation and amortization	6,975	7,568
Operating EBITDA <sup>(1)</sup>	12,776	5,961

(1) See Note 9 of the consolidated condensed financial statements included elsewhere herein for a reconciliation to our consolidated results.

#### **Liquidity and Capital Resources of the Restricted Group**

The following table is a summary of selected financial information for the Restricted Group for the periods indicated:

	<b>As at June 30, 2007</b>	<b>As at December 31, 2006</b>
	<b>(in thousands)</b>	
<b>Restricted Group Financial Position<sup>(1)</sup></b>		
Cash and cash equivalents	40,027	39,078
Working capital <sup>(2)</sup>	98,188	74,961
Property, plant and equipment	397,577	408,957
Total assets <sup>(2)</sup>	627,274	609,515
Long-term liabilities	322,745	318,728
Shareholders' equity	252,616	243,949

(1) See Note 9 of the consolidated

condensed  
financial  
statements  
included  
elsewhere  
herein for a  
reconciliation to  
our consolidated  
results.

- (2) Excluding assets  
and liabilities of  
discontinued  
operations.

At June 30, 2007, the Restricted Group had cash and cash equivalents of 40.0 million, compared to 39.1 million at December 31, 2006. At June 30, 2007, the Restricted Group had working capital of 98.2 million.

We expect the Restricted Group to meet its interest and debt service expenses and meet the working and maintenance capital requirements for its current operations from cash flow from operations, cash on hand and the revolving working capital loan facilities for the Rosenthal and Celgar mills. As at June 30, 2007, we had not drawn any amount under the Rosenthal revolving term credit facility and had drawn down approximately 12.5 million under the C\$40 million Celgar revolving credit facility.

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### **Critical Accounting Policies**

The preparation of financial statements and related disclosures in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Estimates are used for, but not limited to, the accounting for doubtful accounts, depreciation and amortization, asset impairments, derivative financial instruments, environmental conservation, asset retirement obligations, pensions and post-retirement benefit obligations, income taxes, and contingencies. Actual results could differ from these estimates. Our management routinely makes judgments and estimates about the effects of matters that are inherently uncertain. As the number of variables and assumptions affecting the probable future resolution of the uncertainties increase, these judgments become even more subjective and complex. We have identified certain accounting policies that are the most important to the portrayal of our current financial condition and results of operations.

For information about our significant accounting policies, see our annual report on Form 10-K for the year ended December 31, 2006.

### **New Accounting Standard**

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109* ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*, and prescribes a recognition threshold and measurement attributes for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Under FIN 48, the impact of an uncertain income tax position on the income tax return must be recognized at the largest amount that is more likely than not to be sustained upon audit by the relevant taxing authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. Additionally, FIN 48 provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006.

We adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, we recognized no adjustment in the liability for unrecognized tax benefits.

### **Cautionary Statement Regarding Forward-Looking Information**

The statements in this report that are not reported financial results or other historical information are forward-looking statements within the meaning of the *Private Securities Litigation Reform Act of 1995*, as amended. These statements appear in a number of different places in this report and can be identified by words such as estimates, projects, expects, intends, believes, plans, or their negatives or other comparable words. Also look for discussions of strategies that involve risks and uncertainties. Forward-looking statements include statements regarding the outlook for our future operations, forecasts of future costs and expenditures, the evaluation of market conditions, the outcome of legal proceedings, the adequacy of reserves, or other business plans. You are cautioned that any such forward-looking statements are not guarantees and may involve risks and uncertainties. Our actual results may differ materially from those in the forward-looking statements due to risks facing us or due to actual facts differing from the

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assumptions underlying our estimates. Some of these risks and assumptions include those set forth in reports and other documents we have filed with or furnished to the SEC, including in our annual report on Form 10-K for the year ended December 31, 2006. We advise you that these cautionary remarks expressly qualify in their entirety all forward-looking statements attributable to us or persons acting on our behalf. Unless required by law, we do not assume any obligation to update forward-looking statements based on unanticipated events or changed expectations. However, you should carefully review the reports and other documents we file from time to time with the SEC.

### **Cyclical Nature of Business**

#### *Revenues*

The pulp business is cyclical in nature and markets for our principal products are characterized by periods of supply and demand imbalance, which in turn affects product prices. Pulp markets are highly competitive and are sensitive to cyclical changes in the global economy, industry capacity and foreign exchange rates, all of which can have a significant influence on selling prices and our earnings. The length and magnitude of industry cycles have varied over time but generally reflect changes in macro economic conditions and levels of industry capacity.

Industry capacity can fluctuate as changing industry conditions can influence producers to idle production or permanently close machines or entire mills. In addition, to avoid substantial cash costs in idling or closing a mill, some producers will choose to operate at a loss, sometimes even a cash loss, which can prolong weak pricing environments due to oversupply. Oversupply of our products can also result from producers introducing new capacity in response to favorable pricing trends.

Demand for pulp has historically been determined by the level of economic growth and has been closely tied to overall business activity. Although pulp prices have improved commencing in the latter part of 2005 and through the second quarter of 2007, we cannot predict the impact of future economic weakness in certain world markets or the impact of war, terrorist activity or other events on our markets.

Prices for pulp are driven by many factors outside our control, and we have little influence over the timing and extent of price changes, which are often volatile. Because market conditions beyond our control determine the prices for our products, the price for pulp may fall below our cash production costs, requiring us to either incur short-term losses on product sales or cease production at one or more of our manufacturing facilities. Therefore, our profitability with respect to pulp depends on managing our cost structure, particularly raw materials which represent a significant component of our operating costs and can fluctuate based upon factors beyond our control. If the prices of our products decline, or if raw materials increase, or both, demand for our products may decline and our sales and profitability could be materially adversely affected.

#### *Costs*

Our production costs are influenced by the availability and cost of raw materials, energy and labor, and our plant efficiencies and productivity. Our main raw material is fiber in the form of wood chips and pulp logs. Fiber costs are primarily affected by the supply of, and demand for, lumber which is highly cyclical in nature and can vary significantly by location. Production costs also depend on the total volume of production. Lower operating rates and production efficiencies during periods of cyclically low demand result in higher average production costs and lower margins.

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### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to market risks from changes in interest rates and foreign currency exchange rates, particularly the exchange rate between the U.S. dollar and the Euro and to a lesser extent the Canadian dollar, which may affect our results of operations and financial condition and, consequently, our fair value. We manage these risks through internal risk management policies and, with respect to risks related to changes in exchange rates between the U.S. dollar and the Euro, with the use of derivatives. We use derivatives to reduce or limit our exposure to interest rate and U.S. dollar/Euro currency risks. We may in the future use derivatives to reduce or limit our exposure to fluctuations in pulp prices. We also use derivatives to reduce our potential losses or to augment our potential gains, depending on our management's perception of future economic events and developments. These types of derivatives are generally highly speculative in nature. They are also very volatile as they are highly leveraged given that margin requirements are relatively low in proportion to notional amounts.

Many of our strategies, including the use of derivatives, and the types of derivatives selected by us, are based on historical trading patterns and correlations and our management's expectations of future events. However, these strategies may not be fully effective in all market environments or against all types of risks. Unexpected market developments may affect our risk management strategies during this time, and unanticipated developments could impact our risk management strategies in the future. If any of the variety of instruments and strategies we utilize are not effective, we may incur losses.

All of our derivatives are marked to market at the end of each reporting period, and all unrealized gains and losses are recognized in earnings for a reporting period. We determine market valuations based primarily upon valuations provided by our counterparties.

In the first quarter of 2005, Stendal entered into currency swaps to convert a portion of its indebtedness under the Stendal Loan Facility from Euros into U.S. dollars and certain currency forwards. In April 2005, Stendal entered into a currency swap to convert the balance of its long-term indebtedness under the Stendal Loan Facility from Euros into U.S. dollars. During the first six months of 2007, we recorded an unrealized \$17.9 million net gain before minority interests upon the marked to market valuation of such derivatives compared to a net unrealized gain of \$90.7 million in the comparative period of 2006.

During the current period, we determined that the remaining currency swaps had met our objectives and we settled them. As a result, we realized a gain of \$6.8 million from their original commencement. In the same period of 2006, we realized a loss of \$5.2 million on the settlement of certain currency forwards.

The first quarter settlement of the final currency swaps is consistent with our view that the U.S. dollar is at historically low levels. In addition to the cash consequences of the transaction, the sale of the instruments will also result in a modest reduction in interest expense in the future.

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#### **ITEM 4. CONTROLS AND PROCEDURES**

*Disclosure Controls and Procedures.* Our management, with the participation of our Principal Executive Officer and Principal Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)), as of the end of the period covered by this report. Based on such evaluation, our Principal Executive Officer and Principal Financial Officer have concluded that, as of the end of such period, our disclosure controls and procedures are effective to ensure that information required to be disclosed in the reports that are filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms and to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to management, including its Principal Executive Officer and Principal Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. It should be noted that any system of controls is based in part upon certain assumptions designed to obtain reasonable (and not absolute) assurance as to its effectiveness, and there can be no assurance that any design will succeed in achieving its stated goals.

*Changes in Internal Controls.* There have been no significant changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**PART II. OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

In October 2005, our wholly owned subsidiary, Zellstoff Celgar Limited, received a re-assessment for real property transfer tax payable in British Columbia, Canada, in the amount of approximately 3.5 million in connection with the transfer of the land where the Celgar mill is situated. The Company is contesting the assessment and the amount, if any, that may be payable in connection therewith is not yet determinable.

We are subject to routine litigation incidental to our business. We do not believe that the outcome of such litigation will have a material adverse effect on our business or financial condition.

**ITEM 1A. RISK FACTORS**

There have been no material changes to the factors disclosed in Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2006.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITYHOLDERS**

We held our annual meeting of shareholders on June 12, 2007. At the meeting, our seven directors were re-elected to our board of directors and the selection of PricewaterhouseCoopers LLP as our independent auditors was ratified.

The votes cast by shareholders at the meeting as to the election of directors were as follows:

	Votes For	Votes Withheld	Abstentions and Broker Non-Votes
Jimmy S.H. Lee	24,433,578	271,986	11,500,130
Kenneth A. Shields	24,620,397	85,167	11,500,130
William D. McCartney	24,617,897	87,667	11,500,130
Graeme A. Witts	24,621,397	84,167	11,500,130
Eric Lauritzen	24,621,397	84,167	11,500,130
Guy W. Adams	24,620,397	85,167	11,500,130
George Malpass	24,616,897	88,667	11,500,130

**ITEM 6. EXHIBITS****Exhibit**

No.	Description
31.1	Section 302 Certification of Chief Executive Officer
31.2	Section 302 Certification of Chief Financial Officer
32.1*	Section 906 Certification of Chief Executive Officer
32.2*	Section 906 Certification of Chief Financial Officer

\* In accordance with Release 33-8212 of the Commission, these Certifications: (i) are furnished to the Commission and are not filed for the purposes

of liability  
under the  
Securities  
Exchange Act  
of 1934, as  
amended; and  
(ii) are not to be  
subject to  
automatic  
incorporation by  
reference into  
any of the  
Company's  
registration  
statements filed  
under the  
Securities Act  
of 1933, as  
amended for the  
purposes of  
liability  
thereunder or  
any offering  
memorandum,  
unless the  
Company  
specifically  
incorporates  
them by  
reference  
therein.

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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, thereunto duly authorized.

**MERCER INTERNATIONAL INC.**

By: /s/ David M. Gandossi  
David M. Gandossi  
Secretary and Chief Financial Officer

Date: August 8, 2007  
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