

MERCER INTERNATIONAL INC.

Form 10-Q

November 07, 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 September 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)*

**47-0956945**  
*(I.R.S. Employer  
Identification No.)*

**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)*

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 November 6, 2007.

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**PART I. FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**MERCER INTERNATIONAL INC.**

**CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2007**

**(Unaudited)**

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**MERCER INTERNATIONAL INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
**(Unaudited)**  
**(Euros in thousands)**

	<b>September 30, 2007</b>	<b>December 31, 2006</b>
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	69,441	69,367
Receivables	97,380	75,022
Note receivable, current portion	5,998	7,798
Inventories (Note 4)	96,791	62,857
Prepaid expenses and other	6,356	4,662
Current assets of discontinued operations (Note 10)	1,537	2,094
Total current assets	277,503	221,800
Long-term assets		
Cash, restricted	33,000	57,000
Property, plant and equipment	949,046	972,143
Investments	72	1
Unrealized foreign exchange rate derivative gain		5,933
Deferred note issuance and other costs	5,949	6,984
Deferred income tax	18,016	29,989
Note receivable, less current portion	4,239	8,744
	1,010,322	1,080,794
Total assets	1,287,825	1,302,594
<b>LIABILITIES</b>		
Current liabilities		
Accounts payable and accrued expenses	91,293	84,173
Debt, current portion	34,023	33,903
Current liabilities of discontinued operations (Note 10)	610	1,926
Total current liabilities	125,926	120,002
Long-term liabilities		
Debt, less current portion (Note 8)	822,331	873,928
Unrealized interest rate derivative loss	23,266	41,355
Pension and other post-retirement benefit obligations (Note 6)	19,625	17,954
Capital leases	5,350	6,202
Deferred income tax	16,698	22,911
Other long-term liabilities	3,714	1,441
	890,984	963,791

Total liabilities	1,016,910	1,083,793
Minority interest		
<b>SHAREHOLDERS' EQUITY</b>		
Common shares (Note 8)	202,845	195,642
Additional paid-in capital	134	154
Retained earnings	30,181	15,240
Accumulated other comprehensive income	37,755	7,765
Total shareholders' equity	270,915	218,801
Total liabilities and shareholders' equity	1,287,825	1,302,594

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

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**MERCER INTERNATIONAL INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(Unaudited)**  
**(Euros in thousands, except for income per share)**

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Revenues	191,111	171,248	537,245	463,510
Costs and expenses				
Operating costs	149,440	117,186	429,637	358,740
Operating depreciation and amortization	14,284	13,465	42,003	41,790
	27,387	40,597	65,605	62,980
General and administrative expenses	5,930	5,839	19,494	19,891
(Sale) purchase of emission allowances			(766)	(13,246)
Operating income from continuing operations	21,457	34,758	46,877	56,335
Other income (expense)				
Interest expense	(18,599)	(23,041)	(56,308)	(68,769)
Investment income	2,791	1,080	5,986	4,083
Unrealized foreign exchange gain (loss) on debt	4,626	(704)	7,229	11,469
Realized gain (loss) on derivative instruments (Note 5)			6,820	(5,219)
Unrealized (loss) gain on derivative instruments (Note 5)	(5,696)	(14,473)	12,156	76,251
Total other (expense) income	(16,878)	(37,138)	(24,117)	17,815
Income (loss) before income taxes and minority interest from continuing operations	4,579	(2,380)	22,760	74,150
Income tax benefit (provision) current	(144)	(302)	(877)	(524)
deferred	7,013	2,834	(5,959)	(39,864)
Income before minority interest from continuing operations	11,448	152	15,924	33,762
Minority interest	(742)	5,976	(785)	6,874
Net income from continuing operations	10,706	6,128	15,139	40,636
Net (loss) income from discontinued operations	(10)	600	(198)	1,101
Net income	10,696	6,728	14,941	41,737
Retained earnings (deficit), beginning of period	19,485	(12,961)	15,240	(47,970)

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Retained earnings (deficit), end of period	30,181	(6,233)	30,181	(6,233)
Net income per share from continuing operations (Note 3)				
Basic	0.30	0.18	0.42	1.22
Diluted	0.26	0.18	0.40	1.03
Income per share				
Basic	0.29	0.20	0.41	1.26
Diluted	0.26	0.19	0.39	1.05

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

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**MERCER INTERNATIONAL INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
**(Unaudited)**  
**(Euros in thousands)**

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Net income	10,696	6,728	14,941	41,737
Other comprehensive income:				
Foreign currency translation adjustment	11,665	(943)	29,919	4,417
Pension plan additional minimum liability		(3)		(20)
Unrealized (losses) gains on securities	(16)	22	71	712
Other comprehensive income (loss)	11,649	(924)	29,990	5,109
Total comprehensive income	22,345	5,804	44,931	46,846

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

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**MERCER INTERNATIONAL INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**  
**(Euros in thousands)**

	<b>Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
Cash flows from operating activities:		
Net income	14,941	41,737
Adjustments to reconcile net income to cash flows from operating activities		
Unrealized gains on derivatives	(12,156)	(71,032)
Unrealized foreign exchange gain on debt	(7,229)	(11,469)
Loss (gain) on sale of assets	128	(359)
Operating depreciation and amortization	42,003	42,815
Non-operating amortization	194	205
Minority interest	785	(6,874)
Deferred income taxes	5,959	39,878
Stock compensation expense	350	293
Pension and other post-retirement expense	1,366	1,297
Other	912	14
Changes in current assets and liabilities		
Receivables	(19,314)	(14,936)
Inventories	(31,149)	11,940
Accounts payable and accrued expenses	5,610	(136)
Other	1,939	(106)
Net cash from operating activities	4,339	33,267
Cash flows from (used in) investing activities:		
Cash restricted	24,000	(25,388)
Purchase of property, plant and equipment <sup>(1)</sup>	(2,704)	(23,978)
Proceeds on sale of property, plant and equipment	538	5,000
Notes receivable	4,720	
Pension and other post-retirement benefit funding	(1,201)	(1,352)
Net cash from (used in) investing activities	25,353	(45,718)
Cash flows used in financing activities:		
Decrease in construction costs payable		(270)
Proceeds from borrowings of notes payable and debt		77,300
Proceeds from minority shareholders		5,463
Repayment of notes payable and debt	(26,865)	(80,906)
Proceeds from investment grants		383
Repayment of capital lease obligations	(4,222)	(3,263)
Issuance of shares of common stock	305	145

Net cash used in financing activities	(30,782)	(1,148)
Effect of exchange rate changes on cash and cash equivalents	1,764	(575)
Net increase (decrease) in cash and cash equivalents	674	(14,174)
Cash and cash equivalents, beginning of period <sup>(2)</sup>	69,804	83,547
Cash and cash equivalents, end of period <sup>(3)</sup>	70,478	69,373

(1) Includes amounts received and recorded as a reduction of property, plant and equipment (approximately 9,100) upon the settlement of the Stendal engineering, procurement and construction (EPC) contract.

(2) Includes amounts related to discontinued operations of:  
2007 437 (2006 772) (Note 10)

(3) Includes amounts related to discontinued operations of:  
2007 1,037 (2006 428) (Note 10)

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

**MERCER INTERNATIONAL INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)**  
**(Unaudited)**  
**(Euros in thousands)**

	<b>Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	66,136	75,996
Income taxes	397	310
Supplemental schedule of non-cash investing and financing activities:		
Acquisition of production and other equipment under capital lease obligations	2,088	3,465
Common shares issued in satisfaction of floating rate note	6,728	

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

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**MERCER INTERNATIONAL INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

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

**Note 1. Basis of Presentation**

*Basis of Presentation*

The interim period condensed 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 Global Market and the Toronto Stock Exchange, respectively.

The interim period condensed 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 consolidated 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 condensed 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 condensed 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.

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**MERCER INTERNATIONAL INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

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

**Note 1. Basis of Presentation (continued)**

*New Accounting Standards*

In September 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements ( FAS 157 ). FAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. It is applicable whenever another standard requires or permits assets or liabilities to be measured at fair value, but it does not expand the use of fair value to any new circumstances. FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is in the process of determining the impact, if any, the adoption of FAS 157 will have on its consolidated financial position or results of operations.

In February 2007, the FASB issued Statement of Financial Accounting Standards 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, if any, 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 CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

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

**Note 2. Stock-Based Compensation**

The Company adopted Statement of Financial Accounting Standards No. 123R, Share-Based Payment (FAS 123R), 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 FAS 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 elected to adopt FAS 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 September 30, 2007:

Outstanding Options			Exercisable Options		
Exercise		Weighted Average Remaining Contractual	Weighted Average		Weighted Average
Price Range	Number	Life	Exercise price	Number	Exercise Price
(In U.S. Dollars)		(Years)	(In U.S. Dollars)		(In U.S. Dollars)
\$5.65-6.375	830,000	2.75	\$ 6.29	830,000	\$ 6.29
7.30	30,000	7.75	7.30	30,000	7.30
7.92	68,334	8.00	7.92	68,334	7.92

During the three month period ended September 30, 2007, no options were exercised or cancelled while 135,000 options expired. During the nine month period ended September 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, and 135,000 options expired during the period. The average intrinsic value of the options exercised was \$4.58 per option. During the nine month period ended September 30, 2006, no options were exercised, cancelled or expired.

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**MERCER INTERNATIONAL INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

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

**Note 2. Stock-Based Compensation (continued)**

*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 three and nine month periods ended September 30, 2007 were 88 (2006 85) and 231 (2006 - 292), respectively.

As at September 30, 2007, the total remaining unrecognized compensation cost related to restricted stock amounted to 173, which will be amortized over their remaining vesting period.

During the three and nine month periods ended September 30, 2007, there were restricted stock awards granted of an aggregate of 21,000 (2006 10,000) and 21,000 (2006 20,000), respectively, of our common shares to independent directors and officers of the Company. During the nine month period ended September 30, 2007 and 2006, no restricted stock awards were cancelled.

As at September 30, 2007, the total number of restricted stock awards outstanding was 211,686.

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**MERCER INTERNATIONAL INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

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

**Note 3. Income Per Share**

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Net income from continuing operations    basic	10,706	6,128	15,139	40,636
Interest on convertible notes, net of tax	1,050	1,810	2,956	4,576
Net income from continuing operations diluted	11,756	7,938	18,095	45,212
Net income from continuing operations per share:				
Basic	0.30	0.18	0.42	1.22
Diluted	0.26	0.18	0.40	1.03
Net income from continuing operations	10,706	6,128	15,139	40,636
Net (loss) income from discontinued operations	(10)	600	(198)	1,101
Net income    basic	10,696	6,728	14,941	41,737
Interest on convertible notes, net of tax	1,050	1,810	2,956	4,576
Net income    diluted	11,746	8,538	17,897	46,313
Net income per share:				
Basic	0.29	0.20	0.41	1.26
Diluted	0.26	0.19	0.39	1.05
Weighted average number of common shares outstanding:				
Basic	36,284,343	33,180,444	36,012,152	33,173,279
Effect of dilutive shares:				
Stock options and awards	285,684	313,946	405,326	284,589
Convertible notes	8,678,065	10,645,161	8,920,022	10,645,161
Diluted	45,248,092	44,139,551	45,337,500	44,103,029



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**MERCER INTERNATIONAL INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

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

**Note 4. Inventories**

	<b>September 30, 2007</b>	<b>December 31, 2006</b>
Raw materials	71,372	38,905
Work in process and finished goods	25,419	23,952
	96,791	62,857

**Note 5. Derivatives Transactions**

	<b>Three Months Ended September 30, 2007</b>	<b>2006</b>
Unrealized net loss on interest rate derivatives	(5,696)	(9,702)
Unrealized net loss on foreign exchange derivatives		(4,771)
Unrealized net loss on derivative financial instruments	(5,696)	(14,473)

	<b>Nine Months Ended September 30, 2007</b>	<b>2006</b>
Realized net gain (loss) on foreign exchange derivatives	6,820	(5,219)
Unrealized net gain on interest rate derivatives	18,089	26,624
Unrealized net (loss) gain on foreign exchange derivatives	(5,933)	49,627
Unrealized net gain on derivative financial instruments	12,156	76,251

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**MERCER INTERNATIONAL INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(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 and post-retirement benefit 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 three and nine month periods ended September 30, 2007 totaled 367 (2006 - 445) and 1,201 (2006 - 1,352), respectively.

The Company anticipates based on actuarial estimates that it will make contributions to the pension plan of approximately 1,375 (C\$ 2,041) in 2007.

	<b>Three Months Ended September 30,</b>		<b>2007</b>		<b>2006</b>	
	<b>Pension</b>	<b>Post-</b>	<b>Pension</b>	<b>Post-</b>	<b>Pension</b>	<b>Post-</b>
	<b>Benefits</b>	<b>Retirement</b>	<b>Benefits</b>	<b>Retirement</b>	<b>Benefits</b>	<b>Retirement</b>
		<b>Benefits</b>		<b>Benefits</b>		<b>Benefits</b>
Service cost	215	121	219	112		
Interest cost	349	190	345	186		
Expected return on plan assets	(428)		(384)			
Recognized net loss		16		25		
Net periodic benefit cost	136	327	180	323		

	<b>Nine Months Ended September 30,</b>		<b>2007</b>		<b>2006</b>	
	<b>Pension</b>	<b>Post-</b>	<b>Pension</b>	<b>Post-</b>	<b>Pension</b>	<b>Post-</b>
	<b>Benefits</b>	<b>Retirement</b>	<b>Benefits</b>	<b>Retirement</b>	<b>Benefits</b>	<b>Retirement</b>
		<b>Benefits</b>		<b>Benefits</b>		<b>Benefits</b>
Service cost	623	351	667	339		
Interest cost	1,014	551	1,051	568		
Expected return on plan assets	(1,241)		(1,170)			
Recognized net loss		46		75		
Net periodic benefit cost	396	948	548	982		

**MERCER INTERNATIONAL INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(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 files 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 September 30, 2007, the Company had outstanding 36,285,027 common shares with a par value of \$1.00 per share (2006 33,189,140 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 CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(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 nine months ended September 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**

	<b>September 30, 2007</b>			
	<b>Restricted Group</b>	<b>Unrestricted Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated Group</b>
<b>ASSETS</b>				
Current assets				
Cash and cash equivalents	48,993	20,448		69,441
Receivables	46,413	50,967		97,380
Note receivable, current portion	599	5,399		5,998
Inventories	57,161	39,630		96,791
Prepaid expenses and other	3,762	2,594		6,356
Current assets from discontinued operations	1,537			1,537
Total current assets	158,465	119,038		277,503
Cash, restricted		33,000		33,000
Property, plant and equipment	395,864	553,182		949,046
Other	6,021			6,021
Deferred income tax	11,233	6,783		18,016
Due from unrestricted group	56,561		(56,561)	
Note receivable, less current portion	4,239			4,239
Total assets	632,383	712,003	(56,561)	1,287,825
<b>LIABILITIES</b>				
Current				
Accounts payable and accrued expenses	46,023	45,270		91,293
Debt, current portion		34,023		34,023
Current liabilities from discontinued operations	610			610
Total current liabilities	46,633	79,293		125,926
Debt, less current portion	280,847	541,484		822,331
Due to restricted group		56,561	(56,561)	
Unrealized derivative loss		23,266		23,266
Capital leases	3,847	1,503		5,350
Deferred income tax	4,214	12,484		16,698
Other long-term liabilities	23,327	12		23,339

Total liabilities	358,868	714,603	(56,561)	1,016,910
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**SHAREHOLDERS' EQUITY**

Total shareholders' equity (deficit)	273,515	(2,600)		270,915
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Total liabilities and shareholders' equity	632,383	712,003	(56,561)	1,287,825
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**MERCER INTERNATIONAL INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

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

**Note 9. Restricted Group Supplemental Disclosure (continued)**

**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 CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

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

**Note 9. Restricted Group Supplemental Disclosure (continued)**

**Combined Condensed Statement of Operations**

**Three Months Ended September 30, 2007**

	<b>Restricted Group</b>	<b>Unrestricted Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated Group</b>
Revenues	106,530	84,581		191,111
Operating costs	84,769	64,671		149,440
Operating depreciation and amortization	7,419	6,865		14,284
General and administrative expenses	3,386	2,544		5,930
(Sale) purchase of emission allowances				
	95,574	74,080		169,654
Operating income from continuing operations	10,956	10,501		21,457
Other income (expense)				
Interest expense	(6,996)	(12,540)	937	(18,599)
Investment income	1,321	2,407	(937)	2,791
Unrealized foreign exchange gain on debt	4,545	81		4,626
Derivative financial instruments, net		(5,696)		(5,696)
Total other expense	(1,130)	(15,748)		(16,878)
Income (loss) before income taxes and minority interest from continuing operations	9,826	(5,247)		4,579
Income tax benefit (provision) - current	(13)	(131)		(144)
- deferred	(770)	7,783		7,013
Income before minority interest from continuing operations	9,043	2,405		11,448
Minority interest		(742)		(742)
Net income from continuing operations	9,043	1,663		10,706
Net loss from discontinued operations	(10)			(10)
Net income	9,033	1,663		10,696

**Three Months Ended September 30, 2006**

	<b>Restricted Group</b>	<b>Unrestricted Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated Group</b>
Revenues	95,779	75,469		171,248

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Operating costs	65,595	51,591		117,186
Operating depreciation and amortization	6,383	7,082		13,465
General and administrative expenses	3,399	2,440		5,839
(Sale) purchase of emission allowances				
	75,377	61,113		136,490
Operating income from continuing operations	20,402	14,356		34,758
Other income (expense)				
Interest expense	(8,160)	(15,776)	895	(23,041)
Investment income	1,142	833	(895)	1,080
Unrealized foreign exchange loss on debt	(704)			(704)
Derivative financial instruments, net		(14,473)		(14,473)
Total other expense	(7,722)	(29,416)		(37,138)
Income (loss) before income taxes and minority interest from continuing operations	12,680	(15,060)		(2,380)
Income tax benefit (provision) - current	(100)	(202)		(302)
- deferred	(1,281)	4,115		2,834
Income (loss) before minority interest from continuing operations	11,299	(11,147)		152
Minority interest		5,976		5,976
Net income (loss) from continuing operations.	11,299	(5,171)		6,128
Net income from discontinued operations		600		600
Net income (loss)	11,299	(4,571)		6,728

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**MERCER INTERNATIONAL INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

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

**Note 9. Restricted Group Supplemental Disclosure (continued)**

**Combined Condensed Statement of Operations**

**Nine Months Ended September 30, 2007**

	<b>Restricted Group</b>	<b>Unrestricted Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated Group</b>
Revenues	310,770	226,475		537,245
Operating costs	249,052	180,585		429,637
Operating depreciation and amortization	21,080	20,923		42,003
General and administrative expenses	11,551	7,943		19,494
(Sale) purchase of emission allowances	(264)	(502)		(766)
	281,419	208,949		490,368
Operating income from continuing operations	29,351	17,526		46,877
Other income (expense)				
Interest expense	(21,414)	(37,672)	2,778	(56,308)
Investment income	3,761	5,003	(2,778)	5,986
Unrealized foreign exchange gain on debt	6,808	421		7,229
Derivative financial instruments, net		18,976		18,976
Total other expense	(10,845)	(13,272)		(24,117)
Income before income taxes and minority interest from continuing operations	18,506	4,254		22,760
Income tax provision - current	(469)	(408)		(877)
- deferred	(4,464)	(1,495)		(5,959)
Income before minority interest from continuing operations	13,573	2,351		15,924
Minority interest		(785)		(785)
Net income from continuing operations	13,573	1,566		15,139
Net loss from discontinued operations	(198)			(198)
Net income	13,375	1,566		14,941

**Nine Months Ended September 30, 2006**

	<b>Restricted Group</b>	<b>Unrestricted Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated Group</b>
Revenues	265,531	197,979		463,510

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Operating costs	214,873	143,867		358,740
Operating depreciation and amortization	20,580	21,210		41,790
General and administrative expenses	12,884	7,007		19,891
(Sale) purchase of emission allowances	(3,651)	(9,595)		(13,246)
	244,686	162,489		407,175
Operating income from continuing operations	20,845	35,490		56,335
Other income (expense)				
Interest expense	(24,602)	(46,822)	2,655	(68,769)
Investment income	3,261	3,477	(2,655)	4,083
Unrealized foreign exchange gain on debt	11,469			11,469
Derivative financial instruments, net		71,032		71,032
Total other income (expense)	(9,872)	27,687		17,815
Income before income taxes and minority interest from continuing operations	10,973	63,177		74,150
Income tax provision - current	(322)	(202)		(524)
- deferred	(7,964)	(31,900)		(39,864)
Income before minority interest from continuing operations	2,687	31,075		33,762
Minority interest		6,874		6,874
Net income from continuing operations	2,687	37,949		40,636
Net income from discontinued operations		1,101		1,101
Net income	2,687	39,050		41,737

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**MERCER INTERNATIONAL INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(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 condensed consolidated financial statements.

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

	<b>September 30, 2007</b>	<b>December 31, 2006</b>
Assets		
Cash and cash equivalents	1,037	437
Receivables	500	1,657
	1,537	2,094
Liabilities		
Accounts payable and accrued expenses	610	1,926

Condensed earnings from discontinued operations are as follows:

	<b>Three Months Ended September 30, 2007      2006</b>		<b>Nine Months Ended September 30, 2007      2006</b>	
Revenues	7	3,937	117	37,444
Operating income (loss) from discontinued operations	6	3,073	(130)	3,876
Total other expenses	16	352	68	653
Net (loss) income from discontinued operations	(10)	2,721	(198)	3,223
Earnings per common share from discontinued operations				
- basic		0.02		0.04
Earnings per common share from discontinued operations				
- diluted		0.01		

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**MERCER INTERNATIONAL INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

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

**Note 10. Discontinued Operations (continued)**

Condensed cash flows from discontinued operations are as follows:

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2007</b>	<b>2006</b>
Cash flows (used in) from operating activities	(660)	410
Cash flows from investing activities		4,204
Cash flows from (used in) financing activities	1,260	(4,958)
Cash flows from (used in) discontinued operations	600	(344)

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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 September 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 refer 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 nine and three months ended September 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

#### *Nine Months Ended September 30, 2007 Compared to Nine Months Ended September 30, 2006*

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

	<b>Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
Pulp production (ADMTs)	1,034,592	973,410
Pulp sales (ADMTs)	1,029,674	994,567
Revenues (in millions)	537.2	463.5
NBSK list prices in Europe (\$/ADMT)	\$ 783	\$ 663
Average pulp price realizations ( /ADMT)	517	454
Average Currency Exchange Rates		
/(\$)	0.7435	0.8035
C\$ / \$(1)	1.1048	1.1328
C\$ / \$(2)	1.4844	1.4090

- (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 nine months ended September 30, 2007 increased by approximately 16% to 537.2 million from 463.5 million in the comparative period of 2006, primarily due to higher pulp prices and higher sales volume, partially offset by a weakening of the U.S. dollar versus the Euro. Pulp sales volume increased by approximately 4% to 1,029,674 ADMTs in the first nine months of 2007 compared to 994,567 ADMTs in the comparative period of 2006. List prices for NBSK pulp in Europe were approximately 582 (\$783) per ADMT in the first nine months of 2007 and approximately 533 (\$663) per ADMT in the first nine months of 2006.

Average pulp sales realizations increased to 517 per ADMT in the first nine months of 2007 from 454 per ADMT in the first nine months of 2006. Higher U.S. dollar based pulp prices were partially offset by foreign exchange changes in the period. The U.S. dollar was approximately 8% weaker compared to the Euro from the comparative period of 2006.

Cost of sales and general, administrative and other expenses in the first nine months of 2007 increased to 490.4 million from 407.2 million in the comparative period of 2006, primarily as a result of increased fiber costs and higher sales volume.

During the current period, we took an aggregate of 33 days scheduled annual maintenance and strategic capital downtime at our pulp mills, comprised of 12 days each at our Stendal and Celgar mills and 9 days at our Rosenthal mill. During this 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 50 days maintenance and strategic capital expenditure downtime. In the fourth quarter of 2007, we have no scheduled maintenance downtime planned.

Overall, fiber costs increased by approximately 41% in the first nine months of 2007 versus the same period of 2006 as a result of both a supply imbalance and increased demand. In Germany, the supply imbalance resulted from low harvesting levels in late 2005 and 2006 which were not made up during the course of the year. Increased demand in Germany resulted from higher consumption of wood residuals by renewable energy suppliers. A strong European lumber market at the beginning of 2007 provided some marginal price relief in the latter part of the second quarter and in the third quarter. Fiber costs at our Celgar mill were also higher in the current period compared to the comparative period of 2006 due to reduced North American sawmill activity as a result of weakness in U.S. housing construction. Fiber costs at our Celgar mill were relatively stable over the last two quarters, due to supply optimization and the currency impact on the mill's U.S. sourced fiber. Overall, we currently expect fiber prices to be generally level for the balance of the year but continued weakness in lumber markets may put upward pressure on prices in early 2008. The markets and prices for emission allowances continue to be weak, and as a result our contribution to income from such sale of emission allowances in the first nine months of 2007 was 0.8 million, compared to 13.2 million in the comparative period of 2006.

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 in exchange for a 4% wage reduction and provides for a 3% wage increase in the second half of 2008. The new labor contract is set to expire at the end of 2008.

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Operating depreciation and amortization in the first nine months of 2007 increased marginally to 42.0 million from 41.8 million in the comparative period of 2006.

For the first nine months of 2007, operating income decreased by approximately 17% to 46.9 million from 56.3 million in the first nine months of 2006, primarily due to higher fiber costs, the weakening of the U.S. dollar and the reduction in sales of emission allowances.

Interest expense in the first nine months of 2007 decreased to 56.3 million from 68.8 million in the year ago period, primarily due to a lower level of borrowing by Stendal as it repaid 16.5 million in principal 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 19.0 million before minority interests on our outstanding derivatives at the end of the first nine months 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 71.0 million on our derivatives which included a realized loss of 5.2 million from the settlement of currency forwards.

A portion of our long-term debt is denominated and repayable in foreign currencies, principally U.S. dollars. In the first nine months of 2007, we recorded an unrealized gain of 7.2 million on our foreign currency denominated debt as a result of the weakening of the U.S. dollar during the period, compared to a gain of 11.5 million thereon in the same period of 2006.

In the first nine months of 2007 we increased our provision for deferred income tax by approximately 6.0 million, which is net of the realization of benefits on certain tax deductible depreciation, as well as the tax consequence of the settlement of the Stendal engineering, procurement and construction contract (the EPC contract).

In the first nine months of 2007, minority interest, representing the minority shareholder's proportionate interest in the Stendal mill's income for the period, was 0.8 million, compared to its 6.9 million share of losses in the first nine months of 2006.

We reported net income from continuing operations for the first nine months of 2007 of 15.1 million, or 0.42 per basic and 0.40 per diluted share, which included an aggregate net gain of 26.2 million on our outstanding derivatives and an unrealized foreign exchange gain on our long-term debt. In the first nine months of 2006, we reported net income from continuing operations of 40.6 million, or 1.22 per basic and 1.03 per diluted share, which reflected a net unrealized gain of 82.5 million on our outstanding derivatives and an unrealized non-cash foreign exchange gain on our long-term debt.

We generated Operating EBITDA of 89.1 million and 98.1 million in the nine months ended September 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.

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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 operational 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 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 operational 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 condensed consolidated 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 operational 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>Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(in thousands)</b>	
Net income from continuing operations	15,139	40,636
Minority interest	785	(6,874)
Income taxes	6,836	40,388
Interest expense	56,308	68,769
Investment income	(5,986)	(4,083)
Unrealized foreign exchange gain on debt	(7,229)	(11,469)
Derivative financial instruments, net gain	(18,976)	(71,032)
 Operating income from continuing operations	 46,877	 56,335
Add: Depreciation and amortization	42,197	41,790
 Operating EBITDA	 89,074	 98,125

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

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

	<b>Three Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
Pulp production (ADMTs)	360,986	347,200
Pulp sales (ADMTs)	363,523	338,201
Revenues (in millions)	191.1	171.2
NBSK list prices in Europe (\$/ADMT)	\$ 810	\$ 708
Average pulp price realizations ( /ADMT)	520	482
Average Currency Exchange Rates		
/ (\$)	0.7268	0.7851
C\$ / \$( <sup>(1)</sup> )	1.0446	1.1212
C\$ / ( <sup>(2)</sup> )	1.4367	1.4279

(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 September 30, 2007 increased by approximately 12% to 191.1 million from 171.2 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 partially eroded these gains. Pulp sales volume increased to 363,523 ADMTs in the third quarter of 2007 from 338,201 ADMTs in the comparative quarter of 2006.

List prices for NBSK pulp in Europe were approximately 589 (\$810) per ADMT in the third quarter of 2007, approximately 579 (\$783) per ADMT in the second quarter of 2007 and approximately 556 (\$708) in the third quarter of 2006.

Average pulp sales realizations increased to 520 per ADMT in the third quarter of 2007 from 482 per ADMT in the third quarter of 2006, primarily as a result of stronger U.S. dollar based pulp prices, partially offset by the weaker U.S. dollar.

Cost of sales and general, administrative and other expenses in the third quarter of 2007 increased to 169.7 million from 136.5 million in the comparative quarter of 2006, primarily as a result of higher sales volume and fiber costs. During the current quarter, we took 9 days of scheduled maintenance downtime at our Rosenthal mill. During the comparative quarter of 2006, our pulp mills took approximately 9 days of scheduled maintenance and strategic capital expenditure downtime. In the fourth quarter of 2007, we have no scheduled maintenance downtime planned.

Overall, fiber costs increased by approximately 33% in the third quarter of 2007 versus the same period in 2006 as a result of both a supply imbalance and increased demand. In Germany, the supply imbalance resulted from low

harvesting levels in late 2005 and 2006 which were not made up during the course of the year. Increased demand in Germany resulted from higher consumption of wood residuals by renewable energy suppliers. A strong European lumber market provided some marginal price relief during the current quarter. Overall, we currently expect fiber prices to be generally level for the balance of the year but continued weakness in lumber markets may put upward pressure on prices in early 2008.

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We had no contribution to income from the sale of emission allowances in the third quarter of 2007 and 2006 as a result of continued weak markets.

Operating depreciation and amortization increased moderately to 14.3 million from 13.5 million in the comparative quarter of 2006.

For the third quarter of 2007, operating income decreased by approximately 38% to 21.5 million from 34.8 million in the third quarter of 2006. The decrease was primarily due to higher fiber costs and the weakness of the U.S. dollar relative to the Euro.

Interest expense in the third quarter of 2007 decreased to 18.6 million from 23.0 million in the year ago period, primarily due to a lower level of borrowing by Stendal and the settlement of the cross currency swaps in the first quarter of 2007.

Due to the recent decrease in long-term interest rates, we recorded a non-cash loss of 5.7 million before minority interests on Stendal's outstanding interest rate derivatives during the third quarter of 2007. In the comparative quarter of 2006, we recorded a net loss of 14.5 million on Stendal's then outstanding currency and interest rate derivatives which included a loss of 5.7 million from the settlement of currency forwards.

In the third quarter of 2007, we recorded an unrealized gain on our foreign currency denominated debt of 4.6 million, compared to losses of 0.7 million in the third quarter of 2006.

In the third quarter of 2007, minority interest, representing the minority shareholder's proportionate interest in the Stendal mill's income for the period, was 0.7 million, compared to its 6.0 million share of losses in the third quarter of 2006.

In the current quarter we decreased our provision for deferred income tax by approximately 7.0 million primarily as a result of the timing of realizing the benefit of certain tax deductible depreciation, as well as the tax consequence of the settlement of the Stendal EPC contract.

We reported net income from continuing operations for the third quarter of 2007 of 10.7 million, or 0.30 per basic and 0.26 per diluted share, which included an aggregate net unrealized loss of 1.1 million on our outstanding derivatives and an unrealized foreign exchange gain on our long-term debt. In the third quarter of 2006, we reported net income from continuing operations of 6.1 million, or 0.18 per basic and diluted share, which reflected a net loss of

15.2 million on our outstanding derivatives and an unrealized non-cash foreign exchange gain on our long-term debt. We generated Operating EBITDA of 35.8 million and 48.2 million in the three months ended September 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 nine months of 2007 for additional information relating to Operating EBITDA.

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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 September 30,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(in thousands)</b>	
Net income from continuing operations	10,706	6,128
Minority interest	742	(5,976)
Income taxes	(6,869)	(2,532)
Interest expense	18,599	23,041
Investment income	(2,791)	(1,080)
Unrealized foreign exchange (gain) loss on debt	(4,626)	704
Derivative financial instruments, net loss	5,696	14,473
Operating income from continuing operations	21,457	34,758
Add: Depreciation and amortization	14,351	13,465
Operating EBITDA	35,808	48,223

### **Liquidity and Capital Resources**

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

	As at September 30, 2007	As at December 31, 2006
	(in thousands)	
<b>Financial Position</b>		
Cash and cash equivalents	69,441	69,367
Working capital <sup>(1)</sup>	150,650	101,630
Property, plant and equipment	949,046	972,143
Total assets <sup>(1)</sup>	1,286,288	1,300,500
Long-term liabilities	890,984	963,791
Shareholders' equity	270,915	218,801

(1) Excluding assets and liabilities of discontinued operations.

As at September 30, 2007 and December 31, 2006, our cash and cash equivalents were 69.4 million. We also had 33.0 million of restricted cash in a debt service account related to the financing for the Stendal mill, compared to 57.0 million as at December 31, 2006. As at September 30, 2007, we had not drawn any amount under the 40.0 million Rosenthal revolving term credit facility and had drawn down approximately 15.5 million of the C\$40.0 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 ( Stendal Facility ). Pursuant to the Stendal 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 the Stendal 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.

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***Operating Activities***

Operating activities in the first nine months of 2007 provided cash of \$4.3 million, compared to providing cash of \$33.3 million in the comparative period of 2006. An increase in receivables due primarily to higher sales used cash of \$19.3 million in the first nine months of 2007, compared to an increase in receivables using cash of \$14.9 million in the comparative period of 2006. An increase in inventories used cash of \$31.1 million in the first nine months 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 \$11.9 million in the first nine months of 2006. An increase in accounts payable and accrued expenses provided cash of \$5.6 million in the first nine months of 2007, compared to using cash of \$0.1 million in the comparative period of 2006.

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

***Investing Activities***

Investing activities in the nine months ended September 30, 2007 provided cash of \$25.4 million, primarily due to a drawdown of \$24.0 million from our debt service reserve account under the Stendal Facility to repay principal. The repayment of notes receivable provided cash of \$4.7 million. In the nine months ended September 30, 2006 investing activities used cash of \$45.7 million primarily due to a drawdown under a tranche of the Stendal Facility to increase the restricted cash in Stendal's debt service reserve account of \$25.4 million.

Capital expenditures used cash of \$2.7 million in the first nine months of 2007 compared to using cash of \$24.0 million in the comparative period of 2006.

***Financing Activities***

Financing activities used cash of \$30.8 million in the nine months ended September 30, 2007 primarily due to \$33.9 million of principal repayments of the Stendal Facility in the first nine months of 2007. In the comparative period in 2006, financing activities used cash of \$1.1 million primarily due to a net \$4.0 million principal repayment of 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 nine months of 2007.

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### **Capital Resources**

In addition to our current revolving credit facilities for the Rosenthal and Celgar mills, 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.

### **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 and Canadian dollars. 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 nine months ended September 30, 2007, we reported a net 29.9 million foreign exchange translation gain and, as a result, the cumulative foreign exchange translation gain reported within comprehensive income increased to 41.8 million at September 30, 2007 from 11.9 million at December 31, 2006.

Based upon the exchange rate at September 30, 2007, the U.S. dollar has decreased by approximately 11% in value against the Euro since September 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

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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 condensed consolidated financial statements included herein.

***Restricted Group Results Nine Months Ended September 30, 2007 Compared to Nine Months Ended September 30, 2006***

Total revenues for the Restricted Group for the nine months ended September 30, 2007 increased to 310.8 million from 265.5 million in the comparative period of 2006, primarily because of higher pulp sales from the Rosenthal and Celgar mills and higher prices. Pulp sales realizations for the Restricted Group were 526 per ADMT on average in the nine months ended September 30, 2007 and 460 per ADMT in the comparative period of 2006. The increase in U.S. dollar based NBSK pulp prices was partially offset by the weakening of the U.S. dollar which decreased in value by approximately 8% against the Euro during the period.

Costs of sales and general, administrative and other expenses for the Restricted Group in the nine months ended September 30, 2007 increased to 281.4 million from 244.7 million in the comparative period of 2006, primarily as a result of increased fiber costs and higher sales volumes.

During the current period, we took an aggregate of 21 days scheduled annual maintenance downtime at our Rosenthal and Celgar mills. During the comparative period of 2006, our Rosenthal and Celgar mills took approximately 34 days of scheduled maintenance and strategic capital expenditure downtime, during which Rosenthal completed the installation of a new brownstock washer. In the fourth quarter of 2007, we have no scheduled maintenance downtime planned.

During the scheduled maintenance downtime at Celgar, we implemented the final phase of our Blue Goose capital project consisting of the dryer capacity expansion. These changes have shown improvements in production capacity and operational efficiencies, as evidenced by Celgar achieving daily, monthly and quarterly production records during the third quarter.

The markets and prices for emission allowances continue to be weak, and as a result our contribution to income from the sale of such emission allowances by our Rosenthal pulp mill in the first nine months of 2007 was 0.3 million, compared to 3.7 million in the comparative period of 2006.

Overall, fiber costs of the Restricted Group increased by approximately 47% in the first nine months of 2007 versus the same period of 2006 as a result of both a supply imbalance and increased demand. In Germany, the supply imbalance resulted from low harvesting levels in late 2005 and 2006 which were not made up during the course of the year. Increased demand in Germany resulted from higher consumption of wood residuals by renewable energy suppliers. A strong European lumber market at the beginning of 2007 provided some price relief in the latter part of the second quarter and in the third quarter. Overall, we currently expect fiber prices to be generally level for the balance of the year but continued weakness in lumber markets may put upward pressure on prices in early 2008.

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Operating depreciation and amortization for the Restricted Group increased marginally to 21.1 million in the current period from 20.6 million in the comparative period of 2006.

In the first nine months of 2007, the Restricted Group reported operating income from continuing operations of 29.4 million, compared to 20.8 million in the first nine months of 2006, primarily as a result of improving pulp markets and prices, partially offset by higher fiber prices and a weakening U.S. dollar.

Interest expense for the Restricted Group in the nine months ended September 30, 2007 decreased to 21.4 million from 24.6 million in the same period last year.

In the current period of 2007, the Restricted Group recorded a foreign exchange gain on debt of 6.8 million, compared to a gain of 11.5 million in the comparative period of 2006.

In the first nine months of 2007 the Restricted Group increased the provision for deferred income tax by approximately 4.5 million, which is net of the realization of benefits on certain tax deductible depreciation.

For the nine months ended September 30, 2007, the Restricted Group reported net income from continuing operations of 13.6 million, compared to 2.7 million in the first nine months of 2006, primarily as a result of higher pulp prices and improved productivity and sales.

The Restricted Group generated Operating EBITDA of 50.6 million and 41.4 million in the nine months ended September 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 21.3 million and 20.6 million for the nine months ended September 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 nine months ended September 30, 2007 for additional information relating to such limitations and Operating EBITDA.

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

	<b>Nine Months Ended September 30, 2007                  2006 (in thousands)</b>	
<b>Restricted Group</b>		
Net income from continuing operations <sup>(1)</sup>	13,573	2,687
Income taxes	4,933	8,286
Interest expense	21,414	24,602
Investment and other income	(3,761)	(3,261)
Unrealized foreign exchange gain on debt	(6,808)	(11,469)
Operating income from continuing operations	29,351	20,845
Add: Depreciation and amortization	21,274	20,580
Operating EBITDA <sup>(1)</sup>	50,625	41,425

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

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

Total revenues for the Restricted Group for the three months ended September 30, 2007 increased to 106.5 million from 95.8 million in the comparative quarter of 2006, primarily because of higher pulp sales from both the Celgar and Rosenthal mills and higher prices. Pulp sales realizations for the Restricted Group were 528 per ADMT on average in the three months ended September 30, 2007 and 491 per ADMT in the comparative quarter of 2006. The increase in U.S. dollar based NBSK pulp prices was partially offset by the weakening of the U.S. dollar which decreased in value by approximately 7% versus the Euro.

Costs of sales and general, administrative and other expenses for the Restricted Group in the three months ended September 30, 2007 increased to 95.6 million from 75.4 million in the comparative quarter of 2006, primarily as a result of increased fiber costs and higher sales volumes.

During the current period, we took an aggregate of 9 days scheduled annual maintenance downtime at our Rosenthal mill. During the comparative period of 2006, our Rosenthal and Celgar mills took approximately 1 day of maintenance and strategic capital expenditure downtime, during which Rosenthal completed the installation of a new brownstock washer.

We recorded no contribution to income from the sale of such emission allowances in the third quarter of 2007 or in the comparative period of 2006.

Overall, fiber costs of the Restricted Group increased by approximately 35% in the third quarter of 2007 versus the same period in 2006 as a result of both a supply imbalance and increased demand. In Germany, the supply imbalance resulted from low harvesting levels in late 2005 and 2006 which were not made up during the course of the year. Increased demand in Germany resulted from higher consumption of wood residuals by renewable energy suppliers. A strong European lumber market provided some marginal price relief during the current quarter. Overall, we currently expect fiber prices to be generally level for the balance of the year but continued weakness in lumber markets may put upward pressure on prices in early 2008.

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Operating depreciation and amortization for the Restricted Group increased to 7.4 million in the current quarter from 6.4 million in the comparative quarter of 2006.

In the third quarter of 2007, the Restricted Group reported operating income from continuing operations of 11.0 million, compared to operating income from continuing operations of 20.4 million in the third quarter of 2006. The decrease was primarily as a result of the negative impact of higher fiber costs and the accelerated weakening of the U.S. dollar, particularly against the Canadian dollar.

Interest expense for the Restricted Group in the three months ended September 30, 2007 decreased to 7.0 million from 8.2 million in the year ago period.

In the current quarter of 2007, the Restricted Group recorded a foreign exchange gain on debt of 4.5 million, compared to a loss of 0.7 million in the comparative quarter of 2006.

In the current quarter, the Restricted Group increased the provision for deferred income tax by approximately 0.8 million, which is net of the realization of benefits on certain tax deductible depreciation.

For the three months ended September 30, 2007, the Restricted Group reported net income from continuing operations of 9.0 million, compared to income of 11.3 million in the three months ended September 30, 2006, primarily as a result of higher pulp prices and improved results at our Celgar mill, which were more than offset by higher fiber prices and the weakening U.S. dollar.

The Restricted Group generated Operating EBITDA of 18.4 million and 26.8 million in the three months ended September 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 7.5 million and 6.4 million for the three months ended September 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 nine months ended September 30, 2007 for additional information relating to such limitations and Operating EBITDA.

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

	<b>Three Months Ended September 30, 2007                  2006 (in thousands)</b>	
<b>Restricted Group</b>		
Net income from continuing operations <sup>(1)</sup>	9,043	11,299
Income taxes	783	1,381
Interest expense	6,996	8,160
Investment and other income	(1,321)	(1,142)
Unrealized foreign exchange (gain) loss on debt	(4,545)	704
Operating income from continuing operations	10,956	20,402
Add: Depreciation and amortization	7,486	6,383
Operating EBITDA <sup>(1)</sup>	18,442	26,785

(1) See Note 9 of the condensed consolidated 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 September 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	48,993	39,078
Working capital <sup>(2)</sup>	110,905	74,961
Property, plant and equipment	395,864	408,957
Total assets <sup>(2)</sup>	630,846	609,515
Long-term liabilities	312,235	318,728
Shareholders' equity	273,515	243,949

(1) See Note 9 of the condensed



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

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

At September 30, 2007, the Restricted Group had cash and cash equivalents of 49.0 million, compared to 39.1 million at December 31, 2006. At September 30, 2007, the Restricted Group had working capital of 110.9 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 September 30, 2007, we had not drawn any amount under the Rosenthal revolving term credit facility and had drawn down to approximately 15.5 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 both our significant and critical accounting policies, see our annual report on Form 10-K for the year ended December 31, 2006.

### **New Accounting Standards**

See Notes 1 and 7 to the Company's condensed consolidated financial statements included in Item 1.

### **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 strategy 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 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.

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## **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 third 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 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 Facility from Euros into U.S. dollars. During the first nine months of 2007, we recorded an unrealized \$12.2 million net gain before minority interests upon the marked to market valuation of such derivatives compared to a net unrealized gain of \$76.3 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 3.3 million (C\$4.7 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 6. EXHIBITS**

#### **Exhibit**

<b>No.</b>	<b>Description</b>
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: November 6, 2007  
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