

MERCER INTERNATIONAL INC.

Form 10-Q

November 08, 2006

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, 2006**

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 33,214,140 shares of common stock outstanding as at November 6, 2006.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

MERCER INTERNATIONAL INC.

CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2006

(Unaudited)

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MERCER INTERNATIONAL INC.
CONSOLIDATED CONDENSED BALANCE SHEETS
As at September 30, 2006 and December 31, 2005
(Unaudited)
(Euros in thousands)

	September 30, 2006	December 31, 2005
ASSETS		
Current Assets		
Cash and cash equivalents	69,373	83,547
Cash restricted		7,039
Receivables	83,853	74,315
Note receivable, current portion	7,230	
Inventories	62,508	81,147
Prepaid expenses and other	5,626	5,474
Total current assets	228,590	251,522
Long-Term Assets		
Cash restricted	57,000	24,573
Property, plant and equipment	994,805	1,024,662
Investments	1,396	6,314
Deferred note issuance and other costs	7,329	8,364
Deferred income tax	43,189	78,381
Note receivable, less current portion	4,036	
	1,107,755	1,142,294
Total assets	1,336,345	1,393,816
LIABILITIES		
Current Liabilities		
Accounts payable and accrued expenses	103,321	112,726
Debt, current portion	40,903	27,601
Total current liabilities	144,224	140,327
Long-Term Liabilities		
Debt, less current portion	883,096	922,619
Unrealized foreign exchange rate derivative loss	16,506	61,979
Unrealized interest rate derivative losses	52,022	78,646
Pension and other post-retirement benefit obligations	16,631	17,113
Capital leases and other	8,893	9,945
Deferred income tax	19,130	14,444

	996,278	1,104,746
Total liabilities	1,140,502	1,245,073
Minority Interest		
SHAREHOLDERS EQUITY		
Common shares	181,731	181,586
Additional paid-in capital, stock options	123	14
Deficit	(6,233)	(47,970)
Accumulated other comprehensive income	20,222	15,113
Total shareholders equity	195,843	148,743
Total liabilities and shareholders equity	1,336,345	1,393,816

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

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MERCER INTERNATIONAL INC.
CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS
For Nine Months Ended September 30, 2006 and 2005
(Unaudited)
(Euros in thousands, except for per share data)

	2006	2005
Revenues	500,954	376,430
Costs and expenses:		
Cost of sales	433,432	350,185
	67,522	26,245
General and administrative expenses	(24,344)	(22,399)
Sale of emission allowances	13,246	12,353
Gain on sale of assets	359	
Income from operations	56,783	16,199
Other income (expense)		
Interest expense	(68,129)	(63,320)
Investment income	4,096	1,594
Unrealized foreign exchange gain (loss) on debt	11,469	(1,591)
Realized loss on derivative instruments	(5,219)	(2,455)
Unrealized gain (loss) on derivative instruments	76,251	(67,804)
Impairment of investments		(1,699)
Total other income (expense)	18,468	(135,275)
Income (loss) before income taxes and minority interest	75,251	(119,076)
Income tax (provision) benefit	(40,388)	14,627
Income (loss) before minority interest	34,863	(104,449)
Minority interest	6,874	17,076
Net income (loss)	41,737	(87,373)
(Deficit) retained earnings, beginning of period	(47,970)	69,176
Deficit, end of period	(6,233)	(18,197)
Income (loss) per share		
Basic	1.26	(2.86)
Diluted	1.05	(2.86)

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

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MERCER INTERNATIONAL INC.
CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS
For Three Months Ended September 30, 2006 and 2005
(Unaudited)
(Euros in thousands, except for per share data)

	2006	2005
Revenues	175,185	148,928
Costs and expenses:		
Cost of sales	135,387	140,018
	39,798	8,910
General and administrative expenses	(5,753)	(7,083)
Sale of emission allowances		6,065
Gain on sale of assets	359	
Income from operations	34,404	7,892
Other income (expense)		
Interest expense	(22,092)	(21,911)
Investment income	1,085	613
Unrealized foreign exchange gain (loss) on debt	(704)	5,918
Realized loss on derivative instruments		(284)
Unrealized gain (loss) on derivative instruments	(14,473)	3,335
Total other expense	(36,184)	(12,329)
Loss before income taxes and minority interest	(1,780)	(4,437)
Income tax (provision) benefit	2,532	(6,785)
Income (loss) before minority interest	752	(11,222)
Minority interest	5,976	5,667
Net income (loss)	6,728	(5,555)
Deficit, beginning of period	(12,961)	(12,642)
Deficit, end of period	(6,233)	(18,197)
Income (loss) per share		
Basic	0.20	(0.17)
Diluted	0.19	(0.17)

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

**MERCER INTERNATIONAL INC.
CONSOLIDATED CONDENSED STATEMENTS OF
COMPREHENSIVE INCOME (LOSS)
For Nine Months Ended September 30, 2006 and 2005
(Unaudited)
(Euros in thousands)**

	2006	2005
Net income (loss)	41,737	(87,373)
Other comprehensive income:		
Foreign currency translation adjustment	4,417	4,418
Pension plan additional minimum liability	(20)	412
Unrealized gains on securities		
Unrealized holding gains arising during the period	712	564
Other comprehensive income	5,109	5,394
Total comprehensive income (loss)	46,846	(81,979)

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

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MERCER INTERNATIONAL INC.
CONSOLIDATED CONDENSED STATEMENTS OF
COMPREHENSIVE INCOME (LOSS)
For Three Months Ended September 30, 2006 and 2005
(Unaudited)
(Euros in thousands)

	2006	2005
Net income (loss)	6,728	(5,555)
Other comprehensive (loss) income:		
Foreign currency translation adjustment	(943)	3,300
Pension plan additional minimum liability	(3)	412
Unrealized gains on securities		
Unrealized holding gains arising during the period	22	259
Other comprehensive (loss) income	(924)	3,971
Total comprehensive income (loss)	5,804	(1,584)

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

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MERCER INTERNATIONAL INC.
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
For Nine Months Ended September 30, 2006 and 2005
(Unaudited)
(Euros in thousands)

	2006	2005
Cash Flows from (used in) Operating Activities:		
Net income (loss)	41,737	(87,373)
Adjustments to reconcile net income (loss) to cash flows from operating activities		
Unrealized (gains) losses on derivatives	(71,032)	67,804
Depreciation and amortization	43,020	39,599
Unrealized foreign exchange (gain) loss on debt	(11,469)	1,591
Gain on sale of assets	(359)	
Impairment of investments and securities		1,699
Minority interest	(6,874)	(17,076)
Deferred income taxes	39,878	(14,642)
Stock compensation expense	293	330
Other	14	144
Changes in current assets and liabilities		
Receivables	(14,936)	(20,428)
Inventories	11,940	(9,581)
Accounts payable and accrued expenses	(136)	33,765
Other	(161)	(1,435)
Net cash from (used in) operating activities	31,915	(5,603)
Cash Flows used in Investing Activities:		
Cash restricted	(25,388)	60,650
Purchase of property, plant and equipment	(23,978)	(11,275)
Proceeds from sale of assets	5,000	
Acquisition of Celgar pulp mill		(146,608)
Net cash used in investing activities	(44,366)	(97,233)
Cash Flows from (used in) Financing Activities:		
Decrease in construction costs payable	(270)	(64,348)
Proceeds from borrowings of notes payable and debt	77,300	311,792
Proceeds from minority shareholders	5,463	5,463
Repayment of notes payable and debt	(80,906)	(261,691)
Proceeds from investment grants	383	78,595
Repayment of capital lease obligations	(3,263)	(2,930)
Issuance of shares of common stock	145	67,329
Net cash from (used in) financing activities	(1,148)	134,210

Effect of exchange rate changes on cash and cash equivalents	(575)	8,097
Net (decrease) increase in cash and cash equivalents	(14,174)	39,471
Cash and cash equivalents, beginning of period	83,547	49,568
Cash and cash equivalents, end of period	69,373	89,039
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	75,996	44,597
Income taxes	310	345
Supplemental schedule of non-cash investing and financing activities:		
Acquisition of production and other equipment under capital lease obligations	3,465	2,471

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

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MERCER INTERNATIONAL INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
FOR NINE MONTHS ENDED SEPTEMBER 30, 2006

(Unaudited)

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

Note 1. Significant Accounting Policies

Basis of Presentation

Effective March 1, 2006, the Company was converted from a business trust organized under the laws of the State of Washington to a corporation organized under the laws of the State of Washington. The conversion was effected through the merger of Mercer Inc. with and into an indirect wholly owned Delaware subsidiary company followed by a merger with a direct wholly owned Washington subsidiary company. The conversion effected a change in the Company's legal form, but did not result in any change in its business, management, fiscal year, accounting practices, assets or liabilities (except to the extent of legal and other costs of effecting the conversion and maintaining ongoing corporate status) or location of its principal executive offices and facilities. The Company continues to operate under the name Mercer International Inc. following consummation of the conversion and continues to be engaged in the same business that it was engaged in prior to the conversion and its shares of common stock are quoted and listed for trading on the NASDAQ National Market and the Toronto Stock Exchange, respectively.

The interim period consolidated financial statements contained herein include the accounts of Mercer International Inc. (Mercer Inc.) and its wholly-owned and majority-owned subsidiaries (collectively, the Company). The interim period consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (the SEC). Certain information and footnote disclosure normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such SEC rules and regulations. The interim period consolidated financial statements should be read together with the audited consolidated financial statements and accompanying notes included in the Company's latest annual report on Form 10-K for the fiscal year ended December 31, 2005. In the opinion of the Company, the unaudited consolidated financial statements contained herein contain all adjustments necessary to present a fair statement of the results of the interim periods presented. The results for the periods presented herein may not be indicative of the results for the entire year.

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MERCER INTERNATIONAL INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
FOR NINE MONTHS ENDED SEPTEMBER 30, 2006

(Unaudited)

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

Note 1. Significant Accounting Policies (cont d)

New Accounting Standards

In February 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 (SFAS 155). This Statement amends FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, and Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. This Statement resolves issues addressed in Statement 133 Implementation Issue No. D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets . This Statement will be effective for financial instruments acquired or issued by the Company after the beginning of its 2007 fiscal year. The Company expects that the adoption of this Statement will not have a material effect on its financial condition or results of operations.

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). This interpretation clarifies the recognition threshold and measurement of a tax position taken on a tax return, and requires expanded disclosure with respect to the uncertainty in income taxes. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact that adoption of FIN 48 will have on its financial condition or results of operations.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157). This statement defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company expects that adoption of SFAS 157 will not have a material effect on its financial condition or results of operations.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, Employer s Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statement No. 87, 88, 106 and 132R (SFAS 158). This Statement requires an employer to recognize in its statement of financial position an asset of a plan s over funded status or a liability for a plan s under funded status, measure a plan s assets and its obligations that determine its funded status as of the end of the employer s fiscal year (with limited exceptions), and recognize changes in the funded status of a defined benefit postretirement plan in the year in which the changes occur. SFAS 158 is effective for fiscal years ending after December 15, 2006. The Company is currently evaluating the impact that the adoption of SFAS 158 will have on its financial condition or results of operations.

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MERCER INTERNATIONAL INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
FOR NINE MONTHS ENDED SEPTEMBER 30, 2006

(Unaudited)

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

Note 1. Significant Accounting Policies (cont d)

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108 (SAB 108). SAB 108 provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB 108 permits existing public companies to record the cumulative effect of initially applying this approach in the fiscal year ending after November 15, 2006 by recording necessary correcting adjustments to the carrying values of assets and liabilities as of the beginning of that year with the offsetting adjustment recorded to the opening balance of retained earnings. The Company expects that adoption of SAB 108 will not have a material impact on its financial condition and results of operations.

Note 2. Stock-Based Compensation

The Company adopted Statement of Financial Accounting Standards (SFAS) No. 123R, *Share-Based Payment*, on January 1, 2006. This statement requires the Company to recognize the cost of employee services received in exchange for the Company's equity instruments. Under SFAS No. 123R, the Company is required to record compensation expense over an award's vesting period based on the award's fair value at the date of grant. The Company has elected to adopt SFAS No. 123R on a modified prospective basis; accordingly, the financial statements for periods prior to January 1, 2006 will not include compensation cost calculated under the fair value method. Prior to January 1, 2006, the Company applied Accounting Principles Board Opinion 25, *Accounting for Stock Issued to Employees*, and, therefore, recorded the intrinsic value of stock-based compensation as expense and applied the disclosure provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation prior to January 1, 2006.

	Nine Months Ended September 30, 2005
Net Loss	
As reported	(87,373)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of any related tax effects	(51)
Pro forma	(87,424)
Basic and Diluted Loss Per Share	
As reported	(2.86)
Pro forma	(2.86)

MERCER INTERNATIONAL INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
FOR NINE MONTHS ENDED SEPTEMBER 30, 2006

(Unaudited)

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

Note 2. Stock-Based Compensation (cont d)

	Three Months Ended September 30, 2005
Net Loss	
As reported	(5,555)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of any related tax effects	(30)
Pro forma	(5,585)
Basic and Diluted Loss Per Share	
As reported	(0.17)
Pro forma	(0.17)

The fair value of each option granted is estimated on the grant date using the Black-Scholes model. During the nine month period ended September 30, 2006, no options were granted, exercised or cancelled, and during the nine months ended September 30, 2005, 130,000 options were granted to purchase common shares and no options were exercised or cancelled.

Summarized information about stock options outstanding and exercisable at September 30, 2006 is as follows:

Outstanding Options			Exercisable Options		
Exercise Price Range	Number	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise price (In U.S. Dollars)	Number	Weighted Average Exercise Price (In U.S. Dollars)
(In U.S. Dollars)					
\$5.65 - 6.375	920,000	3.75	\$ 6.30	920,000	\$ 6.30
8.50	135,000	0.75	8.50	135,000	8.50
7.30	30,000	8.75	7.30	20,000	7.30
7.92	100,000	9.00	7.92	66,666	7.92
	1,185,000		\$ 6.71	1,141,666	\$ 6.67

As at September 30, 2006, the total remaining unrecognized compensation cost related to non-vested stock options amounted to 181, which will be amortized over their remaining vesting period.

During the nine-month period ended September 30, 2006, the number of non-vested options decreased by 76,667.

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MERCER INTERNATIONAL INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
FOR NINE MONTHS ENDED SEPTEMBER 30, 2006

(Unaudited)

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

Note 2. Stock-Based Compensation (cont d)

Restricted Stock

The fair value of restricted stock is determined based upon the number of shares granted and the quoted price of the Company's stock on the date of grant. Restricted stock generally vests over two years. Expense is recognized on a straight-line basis over the vesting period. Expense recognized for the nine months ended September 30, 2006 and 2005 was 292 and 330, respectively.

As at September 30, 2006, the total remaining unrecognized compensation cost related to restricted stock amounted to 232, which will be amortized over their remaining vesting period.

During the nine month period ended September 30, 2006, there were restricted stock awards of an aggregate of 20,000 of our common shares to independent directors and an officer of the Company.

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