MERCER INTERNATIONAL INC.
Form 10-Q
August 05, 2010

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the quarterly period ended June 30, 2010

OR

o **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	**47-0956945**
(*State or other jurisdiction of incorporation or organization)*	*(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 þ NO o

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months or for such shorter period that the registrant was required to submit and post such files). YES o NO o

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 o	Accelerated Filer o	Non-Accelerated Filer þ (Do not check if a smaller reporting company)	Smaller Reporting Company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES o NO þ

The Registrant had 36,551,325 shares of common stock outstanding as at August 4, 2010.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

MERCER INTERNATIONAL INC.
INTERIM CONSOLIDATED FINANCIAL STATEMENTS
FOR THE SIX MONTHS ENDED JUNE 30, 2010
(Unaudited)

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MERCER INTERNATIONAL INC.
INTERIM CONSOLIDATED BALANCE SHEETS
(Unaudited)
(In thousands of Euros)

	June 30, 2010	December 31, 2009
ASSETS		
Current assets		
Cash and cash equivalents	62,145	51,291
Receivables	125,105	71,143
Inventories (Note 4)	89,582	72,629
Prepaid expenses and other	7,448	5,871
Total current assets	284,280	200,934
Long-term assets		
Property, plant and equipment	872,843	868,558
Deferred note issuance and other	7,627	8,186
Deferred income tax	3,860	3,426
Note receivable	2,202	2,727
	886,532	882,897
Total assets	1,170,812	1,083,831
LIABILITIES		
Current liabilities		
Accounts payable and accrued expenses	105,050	85,185
Pension and other post-retirement benefit obligations (Note 7)	653	567
Debt (Note 5)	23,189	16,032
Total current liabilities	128,892	101,784
Long-term liabilities		
Debt (Note 5)	845,992	813,142
Unrealized interest rate derivative losses (Notes 6 and 9)	63,880	52,873
Pension and other post-retirement benefit obligations (Note 7)	20,932	17,902
Capital leases and other	10,971	12,157
	941,775	896,074
Total liabilities	1,070,667	997,858
EQUITY		
Shareholders equity		
Share capital (Note 8)	202,973	202,844

Paid-in capital	(5,417)	(6,082)
Retained earnings (deficit)	(92,380)	(97,235)
Accumulated other comprehensive income (loss)	26,057	23,695
Total shareholders equity	131,233	123,222
Noncontrolling interest (deficit) (Note 10)	(31,088)	(37,249)
Total equity	100,145	85,973
Total liabilities and equity	1,170,812	1,083,831

Commitments and contingencies (Note 11)

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

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MERCER INTERNATIONAL INC.
INTERIM CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(In thousands of Euros, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	**2009**	**2010**	**2009**
Revenues				
Pulp	228,293	147,522	399,414	276,555
Energy	11,931	11,362	21,062	21,901
	240,224	158,884	420,476	298,456
Costs and expenses				
Operating costs	168,275	149,033	308,684	281,030
Operating depreciation and amortization	14,106	13,539	27,830	26,940
	57,843	(3,688)	83,962	(9,514)
Selling, general and administrative expenses	9,955	6,032	18,050	13,177
Purchase (sale) of emission allowances		16		(542)
Operating income (loss)	47,888	(9,736)	65,912	(22,149)
Other income (expense)				
Interest expense	(16,898)	(16,319)	(33,321)	(32,868)
Investment income (loss)	117	138	211	(3,064)
Foreign exchange gain (loss) on debt	(9,371)	5,170	(14,602)	754
Gain (loss) on extinguishment of convertible notes (Note 5)			(929)	
Gain (loss) on derivative instruments (Note 6)	(4,462)	7,451	(11,008)	(7,562)
Total other income (expense)	(30,614)	(3,560)	(59,649)	(42,740)
Income (loss) before income taxes	17,274	(13,296)	6,263	(64,889)
Income tax benefit (provision) current	(1,319)	(65)	(1,523)	(114)
deferred		1,888		4,919
Net income (loss)	15,955	(11,473)	4,740	(60,084)
Less: net loss (income) attributable to noncontrolling interest	(3,554)	(3)	115	9,258
Net income (loss) attributable to common shareholders	12,401	(11,476)	4,855	(50,826)

Net income (loss) per share attributable to common shareholders (Note 3)				
Basic	0.34	(0.32)	0.13	(1.40)
Diluted	0.23	(0.32)	0.11	(1.40)

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

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MERCER INTERNATIONAL INC.
INTERIM CONSOLIDATED STATEMENTS OF RETAINED EARNINGS (DEFICIT)
(Unaudited)
(In thousands of Euros)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Net income (loss) attributable to common shareholders	12,401	(11,476)	4,855	(50,826)
Retained earnings (deficit), beginning of period	(104,781)	(74,396)	(97,235)	(35,046)
Retained earnings (deficit), end of period	(92,380)	(85,872)	(92,380)	(85,872)

INTERIM CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(Unaudited)
(In thousands of Euros)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Net income (loss)	15,955	(11,473)	4,740	(60,084)
Other comprehensive income (loss)				
Foreign currency translation adjustment	(4,688)	14,603	2,944	9,234
Pension income (expense)	(234)	(22)	(600)	(39)
Unrealized gains (losses) on securities arising during the period	12	21	18	335
Other comprehensive income (loss)	(4,910)	14,602	2,362	9,530
Total comprehensive income (loss)	11,045	3,129	7,102	(50,554)
Comprehensive loss (income) attributable to noncontrolling interest	(3,554)	(3)	115	9,258
Comprehensive income (loss) attributable to common shareholders	7,491	3,126	7,217	(41,296)

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

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MERCER INTERNATIONAL INC.

INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(In thousands of Euros)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	**2009**	**2010**	**2009**
Cash flows from (used in) operating activities				
Net income (loss) attributable to common shareholders	12,401	(11,476)	4,855	(50,826)
Adjustments to reconcile net income (loss) attributable to common shareholders to cash flows from operating activities				
Loss (gain) on derivative instruments	4,462	(7,451)	11,008	7,562
Foreign exchange (gain) loss on debt	9,371	(5,170)	14,602	(754)
Loss (gain) on extinguishment of convertible notes			929	
Depreciation and amortization	14,176	13,604	27,997	27,071
Accretion (income) expense	514		945	
Noncontrolling interest	3,554	3	(115)	(9,258)
Deferred income taxes		(1,888)		(4,919)
Stock compensation expense	227	26	733	(8)
Pension and other post-retirement expense, net of funding	138	(7)	332	(23)
Inventory provisions				4,587
Other	844	925	1,847	(1,974)
Changes in current assets and liabilities				
Receivables	(28,798)	4,727	(45,942)	24,708
Inventories	(5,724)	21,406	(10,983)	27,525
Accounts payable and accrued expenses	5,377	15,161	13,332	7,940
Other	687	(366)	(594)	634
Net cash from (used in) operating activities	17,229	29,494	18,946	32,265
Cash flows from (used in) investing activities				
Purchase of property, plant and equipment	(14,542)	(7,835)	(20,392)	(15,541)
Proceeds on sale of property, plant and equipment	162	103	549	232
Cash, restricted				9,469
Notes receivable	579	120	495	241
Net cash from (used in) investing activities	(13,801)	(7,612)	(19,348)	(5,599)
Cash flows from (used in) financing activities				
Repayment of notes payable and debt			(8,250)	(13,800)
Repayment of capital lease obligations	(603)	(536)	(1,607)	(1,218)
	6,390		6,390	10,000

Proceeds from borrowings of notes payable and debt				
Proceeds from government grants	1,144		10,559	
Payment of deferred note issuance costs				(1,969)
Net cash from (used in) financing activities	6,931	(536)	7,092	(6,987)
Effect of exchange rate changes on cash and cash equivalents	3,094	(482)	4,164	(31)
Net increase (decrease) in cash and cash equivalents	13,453	20,864	10,854	19,648
Cash and cash equivalents, beginning of period	48,692	41,236	51,291	42,452
Cash and cash equivalents, end of period	62,145	62,100	62,145	62,100

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

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MERCER INTERNATIONAL INC.
INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)
(Unaudited)
(In thousands of Euros)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	**2009**	**2010**	**2009**
Supplemental disclosure of cash flow information				
Cash paid (received) during the period for				
Interest	14,604	2,952	29,033	31,210
Income taxes	(37)	43	29	72
Supplemental schedule of non-cash investing and financing activities				
Acquisition of production and other equipment under capital lease obligations	318	80	530	116
Decrease in accounts payable relating to investing activities	(12,843)	(1,602)	(13,826)	(1,141)

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

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MERCER INTERNATIONAL INC.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(In thousands of Euros, except per share data)

Note 1. The Company and Summary of Significant Accounting Policies

Basis of Presentation

The interim 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 both the NASDAQ Global Market and the Toronto Stock Exchange.

The interim 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 consolidated balance sheet data was derived from audited financial statements. The footnote disclosure included herein has been prepared in accordance with accounting principles generally accepted for interim financial statements in the United States (GAAP). The interim 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, 2009. In the opinion of the Company, the unaudited interim consolidated financial statements contained herein contain all adjustments necessary to fairly present the results of the interim periods included. The results for the periods included herein may not be indicative of the results for the entire year.

The Company has three pulp mills that are aggregated into one reportable business segment, market pulp. Accordingly, the results presented are those of the reportable business segment.

Certain prior year amounts in the interim consolidated financial statements have been reclassified to conform to the current year presentation.

In these interim consolidated financial statements, unless otherwise indicated, all amounts are expressed in Euros ( ). The term U.S. dollars and the symbol $ refer to United States dollars. The symbol C$ refers to Canadian dollars.

Use of Estimates

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. Significant management judgment is required in determining the accounting for, among other things, doubtful accounts and reserves, depreciation and amortization, future cash flows associated with impairment testing for long-lived assets, derivative financial instruments, environmental conservation and legal liabilities, asset retirement obligations, pensions and post-retirement benefit obligations, income taxes, contingencies, and inventory obsolescence and provisions. Actual results could differ from these estimates, and changes in these estimates are recorded when known.

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MERCER INTERNATIONAL INC.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(In thousands of Euros, except per share data)

Note 1. The Company and Summary of Significant Accounting Policies (continued)

Recently Implemented Accounting Standards

This section highlights recently implemented accounting standards that had an impact on the Company s financial statements.

In January 2010, the Company adopted Accounting Standards Update (ASU) 2010-06, which amends Accounting Standards Codification 820 (ASC 820), *Fair Value Measurements and Disclosures.* This new accounting guidance requires expanded fair value measurement disclosures in quarterly and annual financial statements. The new guidance clarifies existing disclosure requirements for the Level 2 and 3 fair value measurement. Additionally, the new guidance also requires details of significant transfers of assets between Level 1 and Level 2 fair value measurement categories, including the reasons for such transfers, as well as gross presentation of activity within the Level 3 fair value measurement category. This guidance is effective for the Company on January 1, 2010, except for the gross presentation of Level 3 activity, which is effective January 1, 2011. The adoption of this new accounting guidance did not impact the results of operations or the financial position of the Company.

Note 2. Stock-Based Compensation

In June 2010, the Company adopted a new stock incentive plan (the 2010 Plan) which provides for options, restricted stock rights, restricted stock, performance shares, performance share units and stock appreciation rights to be awarded to employees, consultants and non-employee directors. The 2010 Plan replaced the Company s 2004 stock incentive plan (the 2004 Plan). However, the terms of the 2004 Plan will govern prior awards until all awards granted under the 2004 Plan have been exercised, forfeited, cancelled, expired, or otherwise terminated in accordance with the terms thereof. The Company may grant up to a maximum of 2,000,000 common shares plus the number of common shares remaining available for grant pursuant to the 2004 Plan.

Performance Stock

Grants of performance stock comprise rights to receive stock at a future date that are contingent on the Company and the grantee achieving certain performance objectives.

During the three and six months ended June 30, 2010, potential stock based performance awards totaled 578,165, which potentially vest on December 31, 2010 (2009 530,623). Expense (income) recognized for the three and six month periods ended June 30, 2010 was 194 and 709, respectively (2009 5 and (55)).

The fair value of performance stock is determined based upon the number of shares awarded and the quoted price of the Company s stock at the reporting date. Performance stock generally cliff vest three years from the award date.

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MERCER INTERNATIONAL INC.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(In thousands of Euros, except per share data)

Note 2. Stock-Based Compensation (continued)

On February 11, 2010, the Company awarded a total of 13,000 performance stock to two employees. As of June 30, 2010, no performance stock had vested (2009 nil). During the three and six month period ended June 30, 2010, no performance stock were cancelled (2009 nil and nil).

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 one year. Expense is recognized on a straight-line basis over the vesting period. Expense recognized for the three and six month periods ended June 30, 2010 was 22 and 24, respectively (2009 21 and 47).

In the second quarter, 56,000 restricted stock awards were granted to directors of the Company (2009 nil). No restricted stock awards were granted in the first quarter of 2010 or 2009 and there were no restricted stock awards cancelled during the three and six month periods ended June 30, 2010 (2009 nil and nil). As at June 30, 2010, 77,000 restricted stock awards remain unvested.

As at June 30, 2010, the total remaining unrecognized compensation cost related to restricted stock amounted to approximately 226 (2009 nil), which will be amortized over their remaining vesting periods.

Stock Options

During the three and six month periods ended June 30, 2010 and 2009, no options were exercised, cancelled or granted and 738,334 options expired during the first quarter of 2010 (2009 nil).

MERCER INTERNATIONAL INC.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(In thousands of Euros, except per share data)

Note 3. Net Income (Loss) Per Share Attributable to Common Shareholders

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	**2009**	**2010**	**2009**
Net income (loss) attributable to common shareholders basic	12,401	(11,476)	4,855	(50,826)
Interest on convertible notes, net of tax	747		1,437	
Net income (loss) attributable to common shareholders diluted	13,148	(11,476)	6,292	(50,826)
Net income (loss) per share attributable to common shareholders				
Basic	0.34	(0.32)	0.13	(1.40)
Diluted	0.23	(0.32)	0.11	(1.40)
Weighted average number of common shares outstanding				
Basic[(1)]	36,349,340	36,289,181	36,334,846	36,287,115
Effect of dilutive instruments				
Performance rights	425,668		429,865	
Restricted stock	22,067		16,498	
Stock options and awards				
Convertible notes	20,197,563		20,212,058	
Diluted	56,994,638	36,289,181	56,993,267	36,287,115

(1) The basic weighted average number of shares excludes performance and restricted stock which have been issued, but have not vested as at June 30, 2010 and 2009.

The calculation of diluted net income (loss) per share attributable to common shareholders does not assume the exercise of any instruments that would have an anti-dilutive effect on earnings per share.

Stock options and awards excluded from the calculation of diluted income (loss) per share attributable to common shareholders because they are anti-dilutive represented 190,000 shares for the three and six month periods ended June 30, 2010 (2009 928,334).

Shares associated with the convertible notes excluded from the calculation of diluted income (loss) per share attributable to common shareholders because they are anti-dilutive represented 8,678,065 shares for the three and six month periods ended June 30, 2009.

Performance stock excluded from the calculation of diluted income (loss) per share attributable to common shareholders because they are anti-dilutive represented 369,924 shares for the three and six month periods ended June 30, 2009.

Note 4. Inventories

	June 30, 2010	**December 31, 2009**
Raw materials	39,255	24,888
Finished goods	24,081	24,198
Work in process and other	26,246	23,543
	89,582	72,629

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MERCER INTERNATIONAL INC.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(In thousands of Euros, except per share data)

Note 5. Debt

Debt consists of the following:

	June 30, 2010	December 31, 2009
Note payable to bank, included in a total loan credit facility of 827,950 to finance the construction related to the Stendal mill (a)	506,323	514,574
Senior notes due February 2013, interest at 9.25% accrued and payable semi-annually, unsecured (b)	252,238	216,299
Subordinated convertible notes due October 2010, interest at 8.5% accrued and payable semi-annually (c)	1,851	16,749
Subordinated convertible notes due January 2012, interest at 8.5% accrued and payable semi-annually (d)	50,151	26,160
Credit agreement with a lender with respect to a revolving credit facility of C$40 million (e)	23,782	16,000
Loan payable to the noncontrolling shareholder of the Stendal mill (f)	30,485	35,881
Credit agreement with a bank with respect to a revolving credit facility of 25,000 (g)		
Investment loan agreement with a lender with respect to the wash press project at the Rosenthal mill of 4,351 (h)	4,351	3,511
Credit agreement with a bank with respect to a revolving credit facility of 3,500 (i)		
	869,181	829,174
Less: current portion	(23,189)	(16,032)
Debt, less current portion	845,992	813,142

The Company made scheduled principal repayments under these facilities of 8,250 during the six months ended June 30, 2010 (2009 13,800). As of June 30, 2010, the principal maturities of debt are as follows:

Matures	Amount
2010	8,062
2011	24,255
2012	75,822
2013[1]	317,108
2014	40,543
Thereafter	403,391
	869,181

(1)

Includes revolving credit facility principal amounts totalling 23,782.

MERCER INTERNATIONAL INC.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(In thousands of Euros, except per share data)

Note 5. Debt (continued)

Certain of the Company s debt agreements were issued under an indenture which, among other things, restricts its ability and the ability of its restricted subsidiaries to make certain payments. These limitations are subject to other important qualifications and exceptions. As at June 30, 2010, the Company was in compliance with the terms of the indenture.

(a) Note payable to bank, included in a total loan facility of 827,950 to finance the construction related to the Stendal mill (Stendal Loan Facility), interest at rates varying from Euribor plus 0.90% to Euribor plus 1.50% (rates on amounts of borrowing at June 30, 2010 range from 1.85% to 2.44%), principal due in required installments beginning September 30, 2006 until September 30, 2017, collateralized by the assets of the Stendal mill, with 48% and 32% guaranteed by the Federal Republic of Germany and the State of Saxony-Anhalt, respectively, of up to 468,823 of outstanding principal, subject to a debt service reserve account required to pay amounts due in the following twelve months under the terms of the Stendal Loan Facility; payment of dividends is only permitted if certain cash flow requirements are met.

    On March 13, 2009, the Company finalized an agreement with its lenders to amend its Stendal Loan Facility. The amendment deferred approximately 164,000 of scheduled principal payments until the maturity date, September 30, 2017, including approximately 20,000, 26,000, 21,000 of scheduled principal payments that were originally due in 2009, 2010, and 2011, respectively. The amendment also provided for a 100% cash sweep, referred to as the Cash Sweep , of any cash, in excess of a 15,000 working capital reserve, held by Stendal which will be used first to fund the debt service reserve account to a level sufficient to service the amounts due and payable under the Stendal Loan Facility during the then following 12 months, or Fully Funded , and second to prepay the deferred principal amounts.

(b) In February 2005, the Company issued $310 million of senior notes due February 2013, which bear interest at 9.25% accrued and payable semi-annually, and are unsecured. The Company may redeem all or a part of the notes at redemption prices (expressed as a percentage of principal amount) equal to 102.31% for the twelve month period beginning on February 15, 2010, and 100.00% beginning on February 15, 2011 and at any time thereafter, plus accrued and unpaid interest.

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MERCER INTERNATIONAL INC.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(In thousands of Euros, except per share data)

Note 5. Debt (continued)

(c) As at June 30, 2010, the Subordinated Convertible Notes due October 2010 had approximately $2.3 million of principal outstanding. The Subordinated Convertible Notes due October 2010, bear interest at 8.5% accrued and payable semi-annually, are convertible at any time by the holder into common shares of the Company at $7.75 per share and are unsecured. The Company may redeem for cash all or a portion of these notes at any time at 100% of the principal amount of the notes plus accrued and unpaid interest up to the redemption date. See Note 5(d).

(d) On December 10, 2009, the Company exchanged approximately $43.3 million of Subordinated Convertible Notes due October 2010 through private exchange agreements with the holders thereof for approximately $43.8 million of Subordinated Convertible Notes due January 2012. On January 22, 2010, through an exchange offer, the Company exchanged a further $21.7 million of Subordinated Convertible Notes due October 2010 for approximately $22.0 million of the Company s Subordinated Convertible Notes due January 2012. The Company recognized both exchange transactions of the Subordinated Convertible Notes as extinguishments of debt in accordance with ASC Topic 470, *Debt,* because the fair value of the embedded conversion option changed by more than 10% in both transactions. As a result, for the year ended December 31, 2009, the Company accounted for the December 10, 2009 exchange as a debt extinguishment and recognized a gain of 4,447 in the Consolidated Statement of Operations. For the six months ended June 30, 2010, the Company recognized a loss of 929 as a result of the January 22, 2010 exchange. The gain and loss, which were determined using fair market values prevailing at the time of the transactions, will both be accreted to income through to January 2012 through interest expense yielding an effective interest rate of approximately 13% on the December 10, 2009 exchange and 3% on the January 22, 2010 exchange.

The Subordinated Convertible Notes due January 2012 bear interest at 8.5%, accrued and payable semi-annually, are convertible at anytime by the holder into common shares of the Company at $3.30 per share and are unsecured. The Company may redeem for cash all or a portion of the notes on or after July 15, 2011 at 100% of the principal amount of the notes plus accrued interest up to the redemption date. During the six months ended June 30, 2010, $169,027 of Subordinated Convertible Notes due January 2012 were converted into 51,218 shares.

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MERCER INTERNATIONAL INC.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(In thousands of Euros, except per share data)

Note 5. Debt (continued)

(e) Credit agreement with respect to a revolving credit facility of C$40.0 million for the Celgar mill. The credit agreement matures May 2013. Borrowings under the credit agreement are collateralized by the mill s inventory and receivables and are restricted by a borrowing base calculated on the mill s inventory and receivables. Canadian dollar denominated amounts bear interest at bankers acceptance plus 3.75% or Canadian prime plus 2.00%. U.S. dollar denominated amounts bear interest at LIBOR plus 3.75% or U.S. base plus 2.00%. As at June 30, 2010, this facility was accruing interest at a rate of approximately 4.42% and the undrawn amount was approximately C$8.0 million.

(f) Loans payable to the noncontrolling shareholder of the Stendal mill bear interest at 7%, which is accrued semi-annually. The loan payable is unsecured, subordinated to all liabilities of the Stendal mill, and is due in 2017. The balance includes principal and accrued interest. See Note 10 Noncontrolling Interest.

(g) A 25,000 working capital facility at the Rosenthal mill that matures in December 2012. Borrowings under the facility are collateralized by the mill s inventory and receivables and bear interest at approximately Euribor plus 3.50%. As at June 30, 2010, approximately 2,100 of this facility was supporting bank guarantees leaving approximately 22,900 undrawn.

(h) On August 19, 2009 the Company finalized an investment loan agreement with a lender relating to the new wash press at the Rosenthal mill. The four-year amortizing investment loan was completed with a total facility of 4,351 bearing interest at the rate of Euribor plus 2.75%. Borrowings under this agreement are secured by the new wash press equipment. As at June 30, 2010, this facility was drawn by 4,351 and was accruing interest at a rate of 3.20%.

(i) On February 8, 2010 the Rosenthal mill finalized a credit agreement with a lender for a 3,500 facility maturing in December 2012. Borrowings under the facility will bear interest at the rate of the 3-month Euribor plus 3.5% and are secured by certain land at our Rosenthal mill. As at June 30, 2010, this facility was undrawn.

Note 6. Derivative Transactions

The Company is exposed to certain market risks relating to its ongoing business. The Company seeks to manage these risks through internal risk management policies as well as, from time to time, the use of derivatives. Currently, the primary risk managed using derivative instruments is interest rate risk.

MERCER INTERNATIONAL INC.

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Note 6. Derivative Transactions (continued)

During 2004, the Company entered into certain variable-to-fixed interest rate swaps in connection with the Stendal Loan Facility with respect to an aggregate maximum principal amount of approximately 612,600 of the total indebtedness under the Stendal Loan Facility. Under the interest rate swaps, the Company pays a fixed rate and receives a floating rate with the interest payments being calculated on a notional amount. Currently, the contracts have an aggregate notional amount of 467,926 at a fixed interest rate of 5.28% and they mature October 2017 (generally matching the maturity of the Stendal Loan Facility). The Company substantially converted the Stendal Loan Facility from a variable interest rate loan into a fixed interest rate loan, thereby reducing interest rate uncertainty.

The Company recognized an unrealized loss of 4,462 and 11,008, respectively, with respect to these interest rate swaps for the three and six months ended June 30, 2010 (2009 gain of 7,451 and loss of 7,562), in the Gain (loss) on derivative instruments line in the Interim Consolidated Statement of Operations and Interim Consolidated Statement of Cash Flows. Derivative instruments are required to be measured at their fair value. Accordingly, the fair value of the interest rate swap is presented in Unrealized interest rate derivative losses within the long-term liabilities section in the Interim Consolidated Balance Sheets, which currently amounts to a cumulative unrealized loss of 63,880 (2009 52,873).

The interest rate derivative contracts are with the same banks that hold the Stendal Loan Facility and the Company does not anticipate non-performance by the banks.

Note 7. 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 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 (Celgar Plans).

Pension benefits are based on employees earnings and years of service. The Celgar Plans are funded by contributions from the Company based on actuarial estimates and statutory requirements. Pension contributions for the three and six month periods ended June 30, 2010 totaled 247 and 399, respectively (2009 235 and 583).

The Company anticipates based on actuarial estimates that it will make contributions to the defined benefit pension plan of approximately 319 in 2010.

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Note 7. Pension and Other Post-Retirement Benefit Obligations (continued)

Effective December 31, 2008, the defined benefit plan was closed to new members. In addition, the defined benefit service accrual ceased on December 31, 2008, and members began to receive pension benefits, at a fixed contractual rate, under a new defined contribution plan effective January 1, 2009.

	Three Months Ended June 30,			
	2010		2009	
	Pension Benefits	Post-Retirement Benefits	Pension Benefits	Post-Retirement Benefits
Service cost	21	102	14	84
Interest cost	437	202	377	203
Expected return on plan assets	(409)		(317)	
Recognized net loss (gain)	115	(81)	35	(59)
Net periodic benefit cost	164	223	109	228

	Six Months Ended June 30,			
	2010		2009	
	Pension Benefits	Post-Retirement Benefits	Pension Benefits	Post-Retirement Benefits
Service cost	40	195	28	167
Interest cost	832	384	747	401
Expected return on plan assets	(778)		(628)	
Recognized net loss (gain)	218	(154)	69	(116)
Net periodic benefit cost	312	425	216	452

Note 8. Share Capital

Common shares

The Company has authorized 200,000,000 common shares (2009 200,000,000) with a par value of $1 per share.

During the six months ended June 30, 2010, 51,218 shares were issued as a result of certain holders of the Company s Subordinated Convertible Notes due January 2012 exercising their conversion option. See Note 5(d) Debt.

As at June 30, 2010 and December 31, 2009, the Company had 36,551,325 and 36,443,487 common shares issued and outstanding, respectively.

MERCER INTERNATIONAL INC.

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Note 8. Share Capital (continued)

Preferred shares

The Company has authorized 50,000,000 preferred shares (2009 50,000,000) with $1 par value issuable in series, of which 2,000,000 shares have been designated as Series A. The preferred shares may be issued in one or more series and with such designations and preferences for each series as shall be stated in the resolutions providing for the designation and issue of each such series adopted by the Board of Directors of the Company. The Board of Directors is authorized by the Company s articles of incorporation to determine the voting, dividend, redemption and liquidation preferences pertaining to each such series. As at June 30, 2010, no preferred shares had been issued by the Company.

Note 9. Financial Instruments

The fair value of financial instruments at June 30, 2010 and December 31, 2009 is summarized as follows:

	June 30, 2010		December 31, 2009	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Cash and cash equivalents	62,145	62,145	51,291	51,291
Investments	155	155	135	135
Receivables	125,105	125,105	71,143	71,143
Notes receivable	3,897	3,897	3,819	3,819
Accounts payable and accrued expenses	105,050	105,050	85,185	85,185
Debt	869,181	865,684	829,174	769,207
Interest rate derivative contracts liability	63,880	63,880	52,873	52,873

The carrying value of cash and cash equivalents and accounts payable and accrued expenses approximates the fair value due to the immediate or short-term maturity of these financial instruments. The carrying value of receivables approximates the fair value due to their short-term nature and historical collectability. The fair value of notes receivable was estimated using discounted cash flows at prevailing market rates. The fair value of debt reflects recent market transactions and discounted cash flow estimates. The fair value of the interest rate derivatives is based on observable inputs including applicable yield curves.

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Note 9. Financial Instruments (continued)

The fair value methodologies and, as a result, the fair value of the Company s investments and derivative instruments are determined based on the fair value hierarchy provided in ASC 820. The fair value hierarchy per ASC 820 is as follows:

Level 1 Valuations based on quoted prices in active markets for *identical* assets and liabilities.

Level 2 Valuations based on observable inputs in active markets for *similar* assets and liabilities, other than Level 1 prices, such as quoted interest or currency exchange rates.

Level 3 Valuations based on significant unobservable inputs that are supported by little or no market activity, such as discounted cash flow methodologies based on internal cash flow forecasts.

The Company classified its investments within Level 1 of the valuation hierarchy where quoted prices are available in an active market. Level 1 investments include exchange-traded equities.

The Company s derivatives are classified within Level 2 of the valuation hierarchy, as they are traded on the over-the-counter market and are valued using internal models that use as their basis readily observable market inputs, such as forward interest rates.

The valuation techniques used by the Company are based upon observable inputs. Observable inputs reflect market data obtained from independent sources. In addition, the Company considered the risk of non-performance of the obligor, which in some cases reflects the Company s own credit risk, in determining the fair value of the derivative instruments. The counterparty to our interest rate swap derivative is a multi-national financial institution.

The following table presents a summary of the Company s outstanding financial instruments and their estimated fair values under the hierarchy defined in ASC 820:

		Fair value measurements at June 30, 2010 using:			
Description		Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	Total
Assets					
Investments (a)		155			155
Liabilities					
Derivatives (b)	Interest rate swaps		63,880		63,880

(a) Based on observable market data.

(b) Based on observable

inputs for the liability (yield curves observable at specific intervals).

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Note 10. Noncontrolling Interest

During the first quarter of 2010, the noncontrolling interest holder agreed to convert certain interest claims totaling 6,275 borne from shareholder loans into a capital contribution. As a result of this conversion, the Company reduced the amount owing to the noncontrolling shareholder and decreased the noncontrolling shareholder s share of losses.

Note 11. Commitments and Contingencies

As part of the Company s Green Energy project (the Green Energy Project) for the Celgar mill, during 2009 and 2010 the Company entered into a number of contracts for the purchase of a new 48 megawatt condensing turbine-generator set, as well as other related equipment commitments. As at June 30, 2010, the value of the project remaining to be completed is approximately 9,700 (C$12.6 million), a majority of which is due to be paid within the next year and is being funded by the Canadian Federal Government s Pulp and Paper Green Transformation Program (the Program). Pursuant to a contribution agreement finalized in November 2009, the Program will provide approximately C$40.0 million to complete the Green Energy Project. The Company is also eligible for an additional C$17.7 million under the Program for future qualifying projects.

The Company is involved in a property transfer tax dispute with respect to the Celgar mill and certain other legal actions and claims arising in the ordinary course of business. While the outcome of these legal actions and claims cannot be predicted with certainty, it is the opinion of management that the outcome of any such claim which is pending or threatened, either individually or on a combined basis, will not have a material adverse effect on the consolidated financial condition, results of operations or liquidity of the Company.

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Note 12. Restricted Group Supplemental Disclosure

The terms of the indenture governing our 9.25% senior unsecured notes require 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 three and six months ended June 30, 2010 and 2009, 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.

Combined Condensed Balance Sheet

	June 30, 2010			
	Restricted Group	Unrestricted Subsidiaries	Eliminations	Consolidated Group
ASSETS				
Current assets				
Cash and cash equivalents	39,485	22,660		62,145
Receivables	69,176	55,929		125,105
Inventories	58,250	31,332		89,582
Prepaid expenses and other	4,752	2,696		7,448
Total current assets	171,663	112,617		284,280
Property, plant and equipment	378,462	494,381		872,843
Deferred note issuance and other	3,139	4,488		7,627
Deferred income tax	3,860			3,860
Due from unrestricted group	76,008		(76,008)	
Note receivable	2,202			2,202
Total assets	635,334	611,486	(76,008)	1,170,812
LIABILITIES				
Current liabilities				
Accounts payable and accrued expenses	65,421	39,629		105,050
Pension and other post-retirement benefit obligations	653			653
Debt	2,939	20,250		23,189
Total current liabilities	69,013	59,879		128,892
Debt	329,434	516,558		845,992
Due to restricted group		76,008	(76,008)	
Unrealized interest rate derivative losses		63,880		63,880
Pension and other post-retirement benefit obligations	20,932			20,932
Capital leases and other	6,806	4,165		10,971

Total liabilities	426,185	720,490	(76,008)	1,070,667
EQUITY				
Total shareholders equity (deficit)	209,149	(77,916)		131,233
Noncontrolling interest (deficit)		(31,088)		(31,088)
Total liabilities and equity	635,334	611,486	(76,008)	1,170,812

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Note 12. Restricted Group Supplemental Disclosure (continued)

Combined Condensed Balance Sheet

	December 31, 2009			
	Restricted Group	Unrestricted Subsidiaries	Eliminations	Consolidated Group
ASSETS				
Current assets				
Cash and cash equivalents	20,635	30,656		51,291
Receivables	34,588	36,555		71,143
Inventories	52,897	19,732		72,629
Prepaid expenses and other	3,452	2,419		5,871
Total current assets	111,572	89,362		200,934
Property, plant and equipment	362,311	506,247		868,558
Deferred note issuance and other	3,388	4,798		8,186
Deferred income tax	3,426			3,426
Due from unrestricted group	72,553		(72,553)	
Note receivable	2,727			2,727
Total assets	555,977	600,407	(72,553)	1,083,831
LIABILITIES				
Current liabilities				
Accounts payable and accrued expenses	51,875	33,310		85,185
Pension and other post-retirement benefit obligations	567			567
Debt	2,115	13,917		16,032
Total current liabilities	54,557	47,227		101,784
Debt	276,604	536,538		813,142
Due to restricted group		72,553	(72,553)	
Unrealized interest rate derivative losses		52,873		52,873
Pension and other post-retirement benefit obligations	17,902			17,902
Capital leases and other	6,667	5,490		12,157
Total liabilities	355,730	714,681	(72,553)	997,858
EQUITY				
Total shareholders equity (deficit)	200,247	(77,025)		123,222

Noncontrolling interest (deficit)		(37,249)		(37,249)
Total liabilities and equity	555,977	600,407	(72,553)	1,083,831

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MERCER INTERNATIONAL INC.
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Note 12. Restricted Group Supplemental Disclosure (continued)

Combined Condensed Statements of Operations

	Three Months Ended June 30, 2010			
	Restricted Group	Unrestricted Subsidiaries	Eliminations	Consolidated Group
Revenues				
Pulp	124,840	103,453		228,293
Energy	3,840	8,091		11,931
	128,680	111,544		240,224
Operating costs	95,870	72,405		168,275
Operating depreciation and amortization	7,628	6,478		14,106
Selling, general and administrative expenses and other	6,730	3,225		9,955
	110,228	82,108		192,336
Operating income (loss)	18,452	29,436		47,888
Other income (expense)				
Interest expense	(7,957)	(10,116)	1,175	(16,898)
Investment income (loss)	1,285	7	(1,175)	117
Foreign exchange gain (loss) on debt	(9,371)			(9,371)
Gain (loss) on derivative instruments		(4,462)		(4,462)
Total other income (expense)	(16,043)	(14,571)		(30,614)
Income (loss) before income taxes	2,409	14,865		17,274
Income tax benefit (provision)	(334)	(985)		(1,319)
Net income (loss)	2,075	13,880		15,955
Less: net (income) loss attributable to noncontrolling interest		(3,554)		(3,554)
Net income (loss) attributable to common shareholders	2,075	10,326		12,401

	Three Months Ended June 30, 2009			
	Restricted Group	Unrestricted Subsidiaries	Eliminations	Consolidated Group

Revenues				
Pulp	76,443	71,079		147,522
Energy	3,945	7,417		11,362
	80,388	78,496		158,884
Operating costs	79,793	69,240		149,033
Operating depreciation and amortization	6,888	6,651		13,539
Selling, general and administrative expenses and other	3,314	2,734		6,048
	89,995	78,625		168,620
Operating income (loss)	(9,607)	(129)		(9,736)
Other income (expense)				
Interest expense	(6,927)	(10,513)	1,121	(16,319)
Investment income (loss)	1,234	25	(1,121)	138
Foreign exchange gain (loss) on debt	5,170			5,170
Gain (loss) on derivative instruments		7,451		7,451
Total other income (expense)	(523)	(3,037)		(3,560)
Income (loss) before income taxes	(10,130)	(3,166)		(13,296)
Income tax benefit (provision)	(1,149)	2,972		1,823
Net income (loss)	(11,279)	(194)		(11,473)
Less: net (income) loss attributable to noncontrolling interest		(3)		(3)
Net income (loss) attributable to common shareholders	(11,279)	(197)		(11,476)

MERCER INTERNATIONAL INC.
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Note 12. Restricted Group Supplemental Disclosure (continued)

Combined Condensed Statements of Operations

	Six Months Ended June 30, 2010			
	Restricted Group	Unrestricted Subsidiaries	Eliminations	Consolidated Group
Revenues				
Pulp	231,257	168,157		399,414
Energy	7,215	13,847		21,062
	238,472	182,004		420,476
Operating costs	177,535	131,149		308,684
Operating depreciation and amortization	14,841	12,989		27,830
Selling, general and administrative expenses and other	11,571	6,479		18,050
	203,947	150,617		354,564
Operating income (loss)	34,525	31,387		65,912
Other income (expense)				
Interest expense	(15,277)	(20,380)	2,336	(33,321)
Investment income (loss)	2,524	23	(2,336)	211
Foreign exchange gain (loss) on debt	(14,602)			(14,602)
Gain (loss) on extinguishment of convertible notes	(929)			(929)
Gain (loss) on derivative instruments		(11,008)		(11,008)
Total other income (expense)	(28,284)	(31,365)		(59,649)
Income (loss) before income taxes	6,241	22		6,263
Income tax benefit (provision)	(495)	(1,028)		(1,523)
Net income (loss)	5,746	(1,006)		4,740
Less: net (income) loss attributable to noncontrolling interest		115		115
Net income (loss) attributable to common shareholders	5,746	(891)		4,855

	Six Months Ended June 30, 2009			
	Restricted Group	**Unrestricted Subsidiaries**	**Eliminations**	**Consolidated Group**
Revenues				
Pulp	151,459	125,096		276,555
Energy	7,961	13,940		21,901
	159,420	139,036		298,456
Operating costs	154,228	126,802		281,030
Operating depreciation and amortization	13,592	13,348		26,940
Selling, general and administrative expenses and other	6,617	6,018		12,635
	174,437	146,168		320,605
Operating income (loss)	(15,017)	(7,132)		(22,149)
Other income (expense)				
Interest expense	(14,229)	(20,869)	2,230	(32,868)
Investment income (loss)	2,150	(2,984)	(2,230)	(3,064)
Foreign exchange gain (loss) on debt	754			754
Gain (loss) on derivative instruments		(7,562)		(7,562)
Total other income (expense)	(11,325)	(31,415)		(42,740)
Income (loss) before income taxes	(26,342)	(38,547)		(64,889)
Income tax benefit (provision)	(941)	5,746		4,805
Net income (loss)	(27,283)	(32,801)		(60,084)
Less: net (income) loss attributable to noncontrolling interest		9,258		9,258
Net income (loss) attributable to common shareholders	(27,283)	(23,543)		(50,826)

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Note 12. Restricted Group Supplemental Disclosure (continued)

Combined Condensed Statement of Cash Flows

	Three Months Ended June 30, 2010		
	Restricted Group	Unrestricted Group	Consolidated Group
Cash flows from (used in) operating activities			
Net income (loss) attributable to common shareholders	2,075	10,326	12,401
Adjustments to reconcile net income (loss) attributable to common shareholders to cash flows from operating activities			
Loss (gain) on derivative instruments		4,462	4,462
Foreign exchange loss (gain) on debt	9,371		9,371
Depreciation and amortization	7,698	6,478	14,176
Accretion (income) expense	514		514
Noncontrolling interest		3,554	3,554
Stock compensation expense	227		227
Pension and other post-retirement expense, net of funding	138		138
Other	182	662	844
Changes in current assets and liabilities			
Receivables	(10,186)	(18,612)	(28,798)
Inventories	810	(6,534)	(5,724)
Accounts payable and accrued expenses	10,567	(5,190)	5,377
Other[1]	(4,860)	5,547	687
Net cash from (used in) operating activities	16,536	693	17,229
Cash flows from (used in) investing activities			
Purchase of property, plant and equipment	(14,148)	(394)	(14,542)
Proceeds on sale of property, plant and equipment	9	153	162
Note receivable	579		579
Net cash from (used in) investing activities	(13,560)	(241)	(13,801)
Cash flows from (used in) financing activities			
Repayment of capital lease obligations	(202)	(401)	(603)
Proceeds from borrowings of notes payable and debt	6,390		6,390
Proceeds from government grants	1,144		1,144
Net cash from (used in) financing activities	7,332	(401)	6,931
Effect of exchange rate changes on cash and cash equivalents	3,094		3,094

Net increase (decrease) in cash and cash equivalents	13,402	51	13,453
Cash and cash equivalents, beginning of period	26,083	22,609	48,692
Cash and cash equivalents, end of period	39,485	22,660	62,145

(1) Includes intercompany working capital related transactions.

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Note 12. Restricted Group Supplemental Disclosure (continued)

Combined Condensed Statement of Cash Flows

	Three Months Ended June 30, 2009		
	Restricted Group	Unrestricted Group	Consolidated Group
Cash flows from (used in) operating activities			
Net income (loss) attributable to common shareholders	(11,279)	(197)	(11,476)
Adjustments to reconcile net income (loss) attributable to common shareholders to cash flows from operating activities			
Loss (gain) on derivative instruments		(7,451)	(7,451)
Foreign exchange loss (gain) on debt	(5,170)		(5,170)
Depreciation and amortization	6,953	6,651	13,604
Noncontrolling interest		3	3
Deferred income taxes	1,135	(3,023)	(1,888)
Stock compensation expense	26		26
Pension and other post-retirement expense, net of funding	(7)		(7)
Other	370	555	925
Changes in current assets and liabilities			
Receivables	6,462	(1,735)	4,727
Inventories	9,715	11,691	21,406
Accounts payable and accrued expenses	6,129	9,032	15,161
Other[(1)]	(1,348)	982	(366)
Net cash from (used in) operating activities	12,986	16,508	29,494
Cash flows from (used in) investing activities			
Purchase of property, plant and equipment	(7,352)	(483)	(7,835)
Proceeds on sale of property, plant and equipment	46	57	103
Note receivable	120		120
Net cash from (used in) investing activities	(7,186)	(426)	(7,612)
Cash flows from (used in) financing activities			
Repayment of capital lease obligations	(158)	(378)	(536)
Net cash from (used in) financing activities	(158)	(378)	(536)
Effect of exchange rate changes on cash and cash equivalents	(482)		(482)
Net increase (decrease) in cash and cash equivalents	5,160	15,704	20,864

Cash and cash equivalents, beginning of period	28,682	12,554	41,236 &nbs