

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.

**TABLE OF CONTENTS**

**PART I. FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

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

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

**ITEM 4. CONTROLS AND PROCEDURES**

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

**ITEM 1A. RISK FACTORS**

**ITEM 6. EXHIBITS**

**SIGNATURES**

**PART I. FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**MERCER INTERNATIONAL INC.**

**CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**

**FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2006**

**(Unaudited)**

FORM 10-Q

QUARTERLY REPORT PAGE 2

---

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

|   | <b>September<br/>30,<br/>2006</b> | <b>December<br/>31,<br/>2005</b> |
|---|-----------------------------------|----------------------------------|
| <b>ASSETS</b>   |                                   |                                  |
| 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                        |
|   |                                   |                                  |
| <b>LIABILITIES</b>                                    |                                   |                                  |
| 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                         |           |           |
| <b>SHAREHOLDERS EQUITY</b>                |           |           |
| 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.*

FORM 10-Q

QUARTERLY REPORT PAGE 3

---

**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)**

|   | <b>2006</b> | <b>2005</b> |
|---|-------------|-------------|
| 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.*

FORM 10-Q

QUARTERLY REPORT PAGE 4

---

**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)**

|  | <b>2006</b> | <b>2005</b> |
|--|-------------|-------------|
| 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)**

|  | <b>2006</b> | <b>2005</b> |
|--|-------------|-------------|
| 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.*

FORM 10-Q  
 QUARTERLY REPORT PAGE 6

---

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

|  | <b>2006</b> | <b>2005</b> |
|--|-------------|-------------|
| 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.*

FORM 10-Q  
 QUARTERLY REPORT PAGE 7

---

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

|  | <b>2006</b> | <b>2005</b> |
|--|-------------|-------------|
| 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         |
| <br>   |             |             |
| 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)     |
| <br>   |             |             |
| Net cash from (used in) operating activities                                       | 31,915      | (5,603)     |
| <br>   |             |             |
| 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)   |
| <br>   |             |             |
| Net cash used in investing activities  | (44,366)    | (97,233)    |
| <br>   |             |             |
| 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      |
| <br>   |             |             |
| 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.*

FORM 10-Q

QUARTERLY REPORT PAGE 8

**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.

FORM 10-Q

QUARTERLY REPORT PAGE 9

---

**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.

FORM 10-Q

QUARTERLY REPORT PAGE 10

---

**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.

|   | <b>Nine Months<br/>Ended<br/>September 30,<br/>2005</b> |
|---|---|
| <b>Net Loss</b>   |   |
| 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)  |
| <b>Basic and Diluted Loss Per Share</b>   |   |
| 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)**

|   | <b>Three Months<br/>Ended<br/>September 30, 2005</b> |
|---|--|
| <b>Net Loss</b>   |  |
| 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)  |
| <b>Basic and Diluted Loss Per Share</b>   |  |
| 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:

| <b>Outstanding Options</b>      |               |  | <b>Exercisable Options</b>   |               |  |
|---------------------------------|---------------|--|--|---------------|--|
| <b>Exercise<br/>Price Range</b> | <b>Number</b> | <b>Weighted<br/>Average<br/>Remaining<br/>Contractual<br/>Life<br/>(Years)</b> | <b>Weighted<br/>Average<br/>Exercise<br/>price<br/>(In U.S.<br/>Dollars)</b> | <b>Number</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price<br/>(In U.S.<br/>Dollars)</b> |
| <b>(In U.S. Dollars)</b>        |               |  |  |               |  |
| \$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.

FORM 10-Q

QUARTERLY REPORT PAGE 12

**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.

FORM 10-Q

QUARTERLY REPORT PAGE 13

---

**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 3. Income (Loss) Per Share**

Basic income (loss) per share is computed by dividing income (loss) available to common shareholders by the weighted average number of shares outstanding during a period. Diluted income (loss) per share takes into consideration shares outstanding (computed under basic earnings (loss) per share) and potentially dilutive shares. The following table sets out the computation of basic income (loss) per share for the nine and three months ended September 30, 2006 and 2005, respectively:

|   | Nine Months Ended<br>September 30, |            | Three Months Ended<br>September 30, |            |
|---|------------------------------------|------------|-------------------------------------|------------|
|   | 2006                               | 2005       | 2006                                | 2005       |
| Income (loss) from continuing operations basic        | 41,737                             | (87,373)   | 6,728                               | (5,555)    |
| Interest on convertible notes, net of tax             | 4,576                              |            | 1,810                               |            |
| Income (loss) from continuing operations diluted      | 46,313                             | (87,373)   | 8,538                               | (5,555)    |
| Weighted average number of common shares outstanding: |                                    |            |                                     |            |
| Basic   | 33,173,279                         | 30,557,409 | 33,173,279                          | 33,092,853 |
| Effect of dilutive shares:                            |                                    |            |                                     |            |
| Stock options and awards                              | 284,589                            |            | 313,946                             |            |
| Convertible notes                                     | 10,645,161                         |            | 10,645,161                          |            |
| Diluted   | 44,103,029                         | 30,557,409 | 44,132,386                          | 33,092,853 |
| Income (loss) from continuing operations per share:   |                                    |            |                                     |            |
| Basic   | 1.26                               | (2.86)     | 0.20                                | (0.17)     |
| Diluted   | 1.05                               | (2.86)     | 0.19                                | (0.17)     |

The calculation of diluted income (loss) per share for the comparative 2005 period does not assume the exercise of stock options and awards or the conversion of convertible notes 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 because they are anti-dilutive represented 224,626 for the nine months ended September 30, 2005. Convertible notes excluded from the calculation of diluted income (loss) per share because they are anti-dilutive represented 10,645,161 for the nine months ended September 30, 2005.

FORM 10-Q

QUARTERLY REPORT PAGE 14

**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 4. Acquisition of the Celgar Mill and Related Financings**

*Acquisition*

On February 14, 2005, the Company completed its acquisition of the Celgar NBSK pulp mill. The aggregate consideration for the acquisition was 177,422, which included 142,940 in cash, acquisition related expenditures of 3,668 and 30,814 was paid in common shares of the Company. The results of the Celgar mill are included in the consolidated statement of operations since the acquisition date.

The allocation of the purchase price is summarized below.

Purchase price:

|  |         |
|--|---------|
| Cash (including defined working capital) | 142,940 |
| Equity common shares                     | 30,814  |
| Acquisition costs                        | 3,668   |
|  | 177,422 |

Net assets acquired:

|   |          |
|---|----------|
| Receivables   | 32       |
| Inventories   | 19,969   |
| Prepays and other assets                              | 616      |
| Property, plant and equipment                         | 175,096  |
| Accrued expenses and other liabilities                | (4,103)  |
| Pension plan and post-retirement benefits obligations | (14,188) |
|   | 177,422  |

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

FORM 10-Q

QUARTERLY REPORT PAGE 15

**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 5. Business Segment Information**

The Company operates in two reportable business segments: pulp and paper. The segments are managed separately because each business requires different production and marketing strategies. The results of the Celgar mill presented below are from the date of its acquisition on February 14, 2005.

Summarized financial information concerning the segments is shown in the following table:

|   | <b>Rosenthal<br/>Pulp</b> | <b>Celgar<br/>Pulp</b> | <b>Stendal<br/>Pulp</b> | <b>Total<br/>Pulp</b> | <b>Paper</b> | <b>Corporate,<br/>Other<br/>and<br/>Eliminations</b> | <b>Consolidated<br/>Total</b> |
|---|---------------------------|------------------------|-------------------------|-----------------------|--------------|--|-------------------------------|
| <b>Nine Months<br/>Ended<br/>September 30, 2006</b> |                           |                        |                         |                       |              |  |                               |
| Sales to external customers                         | 109,225                   | 157,431                | 190,514                 | 457,170               | 43,784       |  | 500,954                       |
| Intersegment net sales                              | (1,022)                   | (103)                  | 7,326                   | 6,201                 | (139)        | (6,062)  |                               |
|   | 108,203                   | 157,328                | 197,840                 | 463,371               | 43,645       | (6,062)  | 500,954                       |
| Operating costs                                     | 73,333                    | 140,343                | 143,022                 | 356,698               | 40,038       | (5,645)  | 391,091                       |
| Operating depreciation and amortization             | 10,857                    | 9,491                  | 21,210                  | 41,558                | 551          | 232  | 42,341                        |
| General and administrative                          | 5,565                     | 7,484                  | 7,852                   | 20,901                | 2,828        | 615  | 24,344                        |
| Gain on sale of assets                              |                           |                        |                         |                       | (359)        |  | (359)                         |
| (Sale) purchase of emission allowances              | (3,651)                   |                        | (9,595)                 | (13,246)              |              |  | (13,246)                      |
|   | 86,104                    | 157,318                | 162,489                 | 405,911               | 43,058       | (4,798)  | 444,171                       |
| Income (loss) from operations                       | 22,099                    | 10                     | 35,351                  | 57,460                | 587          | (1,264)  | 56,783                        |
| Interest expense                                    |                           |                        |                         |                       |              |  | (68,129)                      |
| Investment income                                   |                           |                        |                         |                       |              |  | 4,096                         |
| Unrealized foreign exchange gain on debt            |                           |                        |                         |                       |              |  | 11,469                        |
| Derivative financial instruments, net               |                           |                        |                         |                       |              |  | 71,032                        |
|   |                           |                        |                         |                       |              |  | 75,251                        |

Edgar Filing: MERCER INTERNATIONAL INC. - Form 10-Q

Income before  
income taxes and  
minority interest

Segment assets 324,824 239,258 729,148 1,293,230 5,564 37,551 1,336,345

|  | <b>Rosenthal<br/>Pulp</b> | <b>Celgar<sup>(1)</sup><br/>Pulp</b> | <b>Stendal<br/>Pulp</b> | <b>Total<br/>Pulp</b> | <b>Paper</b> | <b>Corporate,<br/>Other<br/>and<br/>Eliminations</b> | <b>Consolidated<br/>Total</b> |
|--|---------------------------|--------------------------------------|-------------------------|-----------------------|--------------|--|-------------------------------|
|--|---------------------------|--------------------------------------|-------------------------|-----------------------|--------------|--|-------------------------------|

**Nine Months  
Ended  
September 30, 2005**

|                             |         |        |         |         |        |  |         |
|-----------------------------|---------|--------|---------|---------|--------|--|---------|
| Sales to external customers | 103,058 | 97,458 | 128,919 | 329,435 | 46,995 |  | 376,430 |
|-----------------------------|---------|--------|---------|---------|--------|--|---------|

|                        |  |  |       |       |  |         |  |
|------------------------|--|--|-------|-------|--|---------|--|
| Intersegment net sales |  |  | 4,679 | 4,679 |  | (4,679) |  |
|------------------------|--|--|-------|-------|--|---------|--|

|  |         |        |         |         |        |         |         |
|--|---------|--------|---------|---------|--------|---------|---------|
|  | 103,058 | 97,458 | 133,598 | 334,114 | 46,995 | (4,679) | 376,430 |
|--|---------|--------|---------|---------|--------|---------|---------|

|                 |        |        |         |         |        |         |         |
|-----------------|--------|--------|---------|---------|--------|---------|---------|
| Operating costs | 73,146 | 86,438 | 112,739 | 272,323 | 44,879 | (5,879) | 311,323 |
|-----------------|--------|--------|---------|---------|--------|---------|---------|

|   |        |       |        |        |     |     |        |
|---|--------|-------|--------|--------|-----|-----|--------|
| Operating depreciation and amortization | 10,173 | 7,083 | 20,179 | 37,435 | 592 | 835 | 38,862 |
|---|--------|-------|--------|--------|-----|-----|--------|

|                            |       |       |       |        |       |       |        |
|----------------------------|-------|-------|-------|--------|-------|-------|--------|
| General and administrative | 5,441 | 5,285 | 3,120 | 13,846 | 3,720 | 4,833 | 22,399 |
|----------------------------|-------|-------|-------|--------|-------|-------|--------|

|  |         |  |         |          |  |  |          |
|--|---------|--|---------|----------|--|--|----------|
| (Sale) purchase of emission allowances | (4,402) |  | (7,951) | (12,353) |  |  | (12,353) |
|--|---------|--|---------|----------|--|--|----------|

|  |        |        |         |         |        |       |         |
|--|--------|--------|---------|---------|--------|-------|---------|
|  | 84,358 | 98,806 | 128,087 | 311,251 | 49,191 | (211) | 360,231 |
|--|--------|--------|---------|---------|--------|-------|---------|

|                               |        |         |       |        |         |         |        |
|-------------------------------|--------|---------|-------|--------|---------|---------|--------|
| Income (loss) from operations | 18,700 | (1,348) | 5,511 | 22,863 | (2,196) | (4,468) | 16,199 |
|-------------------------------|--------|---------|-------|--------|---------|---------|--------|

|                  |  |  |  |  |  |  |          |
|------------------|--|--|--|--|--|--|----------|
| Interest expense |  |  |  |  |  |  | (63,320) |
|------------------|--|--|--|--|--|--|----------|

|                   |  |  |  |  |  |  |       |
|-------------------|--|--|--|--|--|--|-------|
| Investment income |  |  |  |  |  |  | 1,594 |
|-------------------|--|--|--|--|--|--|-------|

|  |  |  |  |  |  |  |         |
|--|--|--|--|--|--|--|---------|
| Unrealized foreign exchange loss on debt |  |  |  |  |  |  | (1,591) |
|--|--|--|--|--|--|--|---------|

|                                       |  |  |  |  |  |  |          |
|---------------------------------------|--|--|--|--|--|--|----------|
| Derivative financial instruments, net |  |  |  |  |  |  | (70,259) |
|---------------------------------------|--|--|--|--|--|--|----------|

|                           |  |  |  |  |  |  |         |
|---------------------------|--|--|--|--|--|--|---------|
| Impairment of investments |  |  |  |  |  |  | (1,699) |
|---------------------------|--|--|--|--|--|--|---------|

|  |  |  |  |  |  |  |           |
|--|--|--|--|--|--|--|-----------|
| Loss before income taxes and minority interest |  |  |  |  |  |  | (119,076) |
|--|--|--|--|--|--|--|-----------|

|                |         |         |         |           |        |       |           |
|----------------|---------|---------|---------|-----------|--------|-------|-----------|
| Segment assets | 341,732 | 251,918 | 787,388 | 1,381,038 | 22,783 | 5,416 | 1,409,237 |
|----------------|---------|---------|---------|-----------|--------|-------|-----------|

- (1) The results of the Celgar pulp mill are from the date of its acquisition on February 14, 2005.

FORM 10-Q

QUARTERLY REPORT PAGE 16

---

**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 5. Business Segment Information (cont d)**

|  | Rosenthal<br>Pulp         | Celgar<br>Pulp         | Stendal<br>Pulp         | Total<br>Pulp         | Paper        | Corporate,<br>Other and<br>Eliminations          | Consolidated<br>Total         |
|--|---------------------------|------------------------|-------------------------|-----------------------|--------------|--|-------------------------------|
| <b>Three Months<br/>Ended<br/>September 30, 2006</b> |                           |                        |                         |                       |              |  |                               |
| Sales to external customers                          | 40,284                    | 56,620                 | 68,004                  | 164,908               | 10,277       |  | 175,185                       |
| Intersegment net sales                               | (870)                     | (126)                  | 2,638                   | 1,642                 | (247)        | (1,395)  |                               |
|  | 39,414                    | 56,494                 | 70,642                  | 166,550               | 10,030       | (1,395)  | 175,185                       |
| Operating costs                                      | 23,880                    | 41,641                 | 47,451                  | 112,972               | 10,067       | (1,211)  | 121,828                       |
| Operating depreciation and amortization              | 3,107                     | 3,200                  | 7,081                   | 13,388                | 95           | 76   | 13,559                        |
| General and administrative                           | 1,973                     | 2,545                  | 1,912                   | 6,430                 | 552          | (1,229)  | 5,753                         |
| Gain on sale of assets                               |                           |                        |                         |                       | (359)        |  | (359)                         |
|  | 28,960                    | 47,386                 | 56,444                  | 132,790               | 10,355       | (2,364)  | 140,781                       |
| Income (loss) from operations                        | 10,454                    | 9,108                  | 14,198                  | 33,760                | (325)        | 969  | 34,404                        |
| Interest expense                                     |                           |                        |                         |                       |              |  | (22,092)                      |
| Investment income                                    |                           |                        |                         |                       |              |  | 1,085                         |
| Unrealized foreign exchange gain on debt             |                           |                        |                         |                       |              |  | (704)                         |
| Derivative financial instruments, net                |                           |                        |                         |                       |              |  | (14,473)                      |
| Loss before income taxes and minority interest       |                           |                        |                         |                       |              |  | (1,780)                       |
|  | <b>Rosenthal<br/>Pulp</b> | <b>Celgar<br/>Pulp</b> | <b>Stendal<br/>Pulp</b> | <b>Total<br/>Pulp</b> | <b>Paper</b> | <b>Corporate,<br/>Other and<br/>Eliminations</b> | <b>Consolidated<br/>Total</b> |
| <b>Three Months<br/>Ended</b>                        |                           |                        |                         |                       |              |  |                               |



**September 30, 2005**

|  |         |         |         |         |         |         |          |
|--|---------|---------|---------|---------|---------|---------|----------|
| Sales to external customers                    | 37,122  | 48,978  | 47,313  | 133,413 | 15,515  |         | 148,928  |
| Intersegment net sales                         |         |         | 1,339   | 1,339   |         | (1,339) |          |
|  | 37,122  | 48,978  | 48,652  | 134,752 | 15,515  | (1,339) | 148,928  |
| Operating costs                                | 25,741  | 45,884  | 41,193  | 112,818 | 15,278  | (2,057) | 126,039  |
| Operating depreciation and amortization        | 3,543   | 2,986   | 6,725   | 13,254  | 213     | 512     | 13,979   |
| General and administrative                     | 1,631   | 2,448   | 1,443   | 5,522   | 1,158   | 403     | 7,083    |
| (Sale) purchase of emission allowances         | (2,267) |         | (3,798) | (6,065) |         |         | (6,065)  |
|  | 28,648  | 51,318  | 45,563  | 125,529 | 16,649  | (1,142) | 141,036  |
| Income (loss) from operations                  | 8,474   | (2,340) | 3,089   | 9,223   | (1,134) | (197)   | 7,892    |
| Interest expense                               |         |         |         |         |         |         | (21,911) |
| Investment income                              |         |         |         |         |         |         | 613      |
| Derivative financial instruments, net          |         |         |         |         |         |         | 3,051    |
| Unrealized foreign exchange loss on debt       |         |         |         |         |         |         | 5,918    |
| Loss before income taxes and minority interest |         |         |         |         |         |         | (4,437)  |

FORM 10-Q  
 QUARTERLY REPORT PAGE 17

**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 6. Inventories**

|                | <b>September 30,<br/>2006</b> | <b>December 31,<br/>2005</b> |
|----------------|-------------------------------|------------------------------|
| Raw materials  | 40,713                        | 42,649                       |
| Finished goods | 21,795                        | 38,498                       |
|                | 62,508                        | 81,147                       |

**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 pulp mills.

The Celgar mill 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 management's best estimates. Pension contributions for the nine month period ended September 30, 2006 and the period from acquisition to September 30, 2005 totaled 1,056 and 994, respectively.

|                                | <b>Nine Months Ended September 30,<br/>2006</b> |                                     | <b>2005</b>                 |                                     |
|--------------------------------|---|-------------------------------------|-----------------------------|-------------------------------------|
|                                | <b>Pension<br/>Benefits</b>                     | <b>Post-Retirement<br/>Benefits</b> | <b>Pension<br/>Benefits</b> | <b>Post-Retirement<br/>Benefits</b> |
| Service cost                   | 667   | 339                                 | 420                         | 183                                 |
| Interest cost                  | 1,051   | 568                                 | 826                         | 402                                 |
| Expected return on plan assets | (1,170)   |                                     | (808)                       |                                     |
| Recognized net loss            |   | 75                                  |                             |                                     |
| Net periodic benefit cost      | 548   | 982                                 | 438                         | 585                                 |

|                                | <b>Three Months Ended September 30,<br/>2006</b> |                                     | <b>2005</b>                 |                                     |
|--------------------------------|--|-------------------------------------|-----------------------------|-------------------------------------|
|                                | <b>Pension<br/>Benefits</b>                      | <b>Post-Retirement<br/>Benefits</b> | <b>Pension<br/>Benefits</b> | <b>Post-Retirement<br/>Benefits</b> |
| Service cost                   | 219  | 112                                 | 175                         | 76                                  |
| Interest cost                  | 345  | 186                                 | 345                         | 168                                 |
| Expected return on plan assets | (384)  |                                     | (337)                       |                                     |
| Recognized net loss            |  | 25                                  |                             |                                     |
| Net periodic benefit cost      | 180  | 323                                 | 183                         | 244                                 |

**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 8. Derivatives Transactions**

|  | <b>Nine Months Ended September<br/>30,</b>  |             |
|--|---|-------------|
|  | <b>2006</b>                                 | <b>2005</b> |
| Realized loss on derivative financial instruments          | (5,219)                                     | (2,455)     |
| Unrealized net gain (loss) on interest rate derivatives    | 26,624                                      | (15,165)    |
| Unrealized net gain (loss) on foreign exchange derivatives | 49,627                                      | (52,639)    |
| Unrealized gain (loss) on derivative financial instruments | 76,251                                      | (67,804)    |
|  | <b>Three Months Ended September<br/>30,</b> |             |
|  | <b>2006</b>                                 | <b>2005</b> |
| Realized loss on derivative financial instruments          |   | (284)       |
| Unrealized net gain (loss) on interest rate derivatives    | (9,702)                                     | 5,310       |
| Unrealized net loss on foreign exchange derivatives        | (4,771)                                     | (1,975)     |
| Unrealized gain (loss) on derivative financial instruments | (14,473)                                    | 3,335       |

FORM 10-Q  
 QUARTERLY REPORT PAGE 19

---

**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 9. Restricted Group Supplemental Disclosure**

The terms of the indenture governing our 9.25% senior unsecured notes requires that the Company provide the results of operations and financial condition of Mercer Inc. and our restricted subsidiaries under the indenture, collectively referred to as the Restricted Group. From February 14, 2005, the Restricted Group includes Mercer Inc., certain holding subsidiaries, Rosenthal and the Celgar mill. The Restricted Group excludes its paper operations and the Stendal mill.

**Combined Condensed Balance Sheet**

|                                       | September 30, 2006  |                              |              |                       |
|---------------------------------------|---------------------|------------------------------|--------------|-----------------------|
|                                       | Restricted<br>Group | Unrestricted<br>Subsidiaries | Eliminations | Consolidated<br>Group |
| <b>ASSETS</b>                         |                     |                              |              |                       |
| Current assets                        |                     |                              |              |                       |
| Cash and cash equivalents             | 37,381              | 31,992                       |              | 69,373                |
| Cash restricted                       |                     |                              |              |                       |
| Receivables                           | 45,683              | 38,170                       |              | 83,853                |
| Note receivable, current portion      | 1,963               | 5,267                        |              | 7,230                 |
| Inventories                           | 38,951              | 23,557                       |              | 62,508                |
| Prepaid expenses and other            | 3,271               | 2,355                        |              | 5,626                 |
| Total current assets                  | 127,249             | 101,341                      |              | 228,590               |
| Cash restricted                       |                     | 57,000                       |              | 57,000                |
| Property, plant and equipment         | 424,205             | 570,600                      |              | 994,805               |
| Other                                 | 3,118               | 5,607                        |              | 8,725                 |
| Deferred income tax                   | 17,093              | 26,096                       |              | 43,189                |
| Due from unrestricted group           | 48,352              |                              | (48,352)     |                       |
| Note receivable, less current portion |                     | 4,036                        |              | 4,036                 |
| Total assets                          | 620,017             | 764,680                      | (48,352)     | 1,336,345             |
| <b>LIABILITIES</b>                    |                     |                              |              |                       |
| Current liabilities                   |                     |                              |              |                       |
| Accounts payable and accrued expenses | 41,532              | 61,789                       |              | 103,321               |
| Debt, current portion                 |                     | 40,903                       |              | 40,903                |
| Total current liabilities             | 41,532              | 102,692                      |              | 144,224               |
| Debt, less current portion            | 317,999             | 565,097                      |              | 883,096               |
| Due to restricted group               |                     | 48,352                       | (48,352)     |                       |
| Unrealized derivative loss            |                     | 68,528                       |              | 68,528                |
| Other                                 | 21,213              | 4,311                        |              | 25,524                |
| Deferred income tax                   | 2,604               | 16,526                       |              | 19,130                |
| Total liabilities                     | 383,348             | 805,506                      | (48,352)     | 1,140,502             |

**SHAREHOLDERS EQUITY**

|   |         |                         |          |           |
|---|---------|-------------------------|----------|-----------|
| Total shareholders equity (deficit)       | 236,669 | (40,826) <sup>(1)</sup> |          | 195,843   |
| Total liabilities and shareholders equity | 620,017 | 764,680                 | (48,352) | 1,336,345 |

(1) Shareholders equity does not include government grants received or receivable related to the Stendal mill. Shareholders equity is impacted by the unrealized non-cash marked to market valuation losses on derivative financial instruments.

FORM 10-Q  
 QUARTERLY REPORT PAGE 20

**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 9. Restricted Group Supplemental Disclosure (cont d)**  
**Combined Condensed Balance Sheet**

|  | December 31, 2005   |                              |              |                       |
|--|---------------------|------------------------------|--------------|-----------------------|
|  | Restricted<br>Group | Unrestricted<br>Subsidiaries | Eliminations | Consolidated<br>Group |
| <b>ASSETS</b>                              |                     |                              |              |                       |
| Current                                    |                     |                              |              |                       |
| Cash and cash equivalents                  | 48,790              | 34,757                       |              | 83,547                |
| Cash restricted                            |                     | 7,039                        |              | 7,039                 |
| Receivables                                | 41,349              | 32,966                       |              | 74,315                |
| Inventories                                | 47,100              | 34,047                       |              | 81,147                |
| Prepaid expenses and other                 | 2,940               | 2,534                        |              | 5,474                 |
| <br>                                       |                     |                              |              |                       |
| Total current assets                       | 140,179             | 111,343                      |              | 251,522               |
| Cash restricted                            |                     | 24,573                       |              | 24,573                |
| Property, plant and equipment              | 404,151             | 620,511                      |              | 1,024,662             |
| Other                                      | 10,533              | 4,145                        |              | 14,678                |
| Deferred income tax                        | 24,303              | 54,078                       |              | 78,381                |
| Due from unrestricted group                | 46,412              |                              | (46,412)     |                       |
| <br>                                       |                     |                              |              |                       |
| Total assets                               | 625,578             | 814,650                      | (46,412)     | 1,393,816             |
| <br>                                       |                     |                              |              |                       |
| <b>LIABILITIES</b>                         |                     |                              |              |                       |
| Current                                    |                     |                              |              |                       |
| Accounts payable and accrued expenses      | 46,867              | 65,859                       |              | 112,726               |
| Debt, current portion                      |                     | 27,601                       |              | 27,601                |
| <br>                                       |                     |                              |              |                       |
| Total current liabilities                  | 46,867              | 93,460                       |              | 140,327               |
| Debt, less current portion                 | 342,023             | 580,596                      |              | 922,619               |
| Due to restricted group                    |                     | 46,412                       | (46,412)     |                       |
| Unrealized derivative loss                 |                     | 140,625                      |              | 140,625               |
| Other                                      | 20,722              | 6,336                        |              | 27,058                |
| Deferred income tax                        | 1,851               | 12,593                       |              | 14,444                |
| <br>                                       |                     |                              |              |                       |
| Total liabilities                          | 411,463             | 880,022                      | (46,412)     | 1,245,073             |
| <br>                                       |                     |                              |              |                       |
| <b>SHAREHOLDERS' EQUITY</b>                |                     |                              |              |                       |
| Total shareholders' equity (deficit)       | 214,115             | (65,372) <sup>(1)</sup>      |              | 148,743               |
| <br>                                       |                     |                              |              |                       |
| Total liabilities and shareholders' equity | 625,578             | 814,650                      | (46,412)     | 1,393,816             |

- (1) Shareholders equity does not include government grants received or receivable related to the Stendal mill. Shareholders equity is impacted by the unrealized non-cash marked to market valuation losses on derivative financial instruments.

FORM 10-Q  
QUARTERLY REPORT PAGE 21

---

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

**Combined Condensed Statement of Operations**

|   | <b>Nine Months Ended September 30, 2006</b> |                                      |                     |                               |
|---|---|--------------------------------------|---------------------|-------------------------------|
|   | <b>Restricted<br/>Group</b>                 | <b>Unrestricted<br/>Subsidiaries</b> | <b>Eliminations</b> | <b>Consolidated<br/>Group</b> |
| Revenues  | 265,531                                     | 241,485                              | (6,062)             | 500,954                       |
| Operating costs   | 214,093                                     | 176,998                              |                     | 391,091                       |
| Operating depreciation and amortization                 | 20,580                                      | 21,761                               |                     | 42,341                        |
| General and administrative expenses                     | 13,664                                      | 10,680                               |                     | 24,344                        |
| (Sale) purchase of emission allowances                  | (3,651)                                     | (9,595)                              |                     | (13,246)                      |
| Gain on sale of assets                                  |   | (359)                                |                     | (359)                         |
|   | 244,686                                     | 199,485                              |                     | 444,171                       |
| Income from operations                                  | 20,845                                      | 42,000                               | (6,062)             | 56,783                        |
| Other income (expense)                                  |   |                                      |                     |                               |
| Interest expense  | (24,602)                                    | (46,182)                             | 2,655               | (68,129)                      |
| Investment income                                       | 3,262                                       | 2,283                                | (1,449)             | 4,096                         |
| Unrealized foreign exchange gain on debt                | 11,469                                      |                                      |                     | 11,469                        |
| Derivative financial instruments, net                   |   | 71,032                               |                     | 71,032                        |
| Total other (expense) income                            | (9,871)                                     | 27,133                               | 1,206               | 18,468                        |
| Income (loss) before income taxes and minority interest | 10,974                                      | 69,133                               | (4,856)             | 75,251                        |
| Income tax provision                                    | (8,094)                                     | (32,102)                             | (192)               | (40,388)                      |
| Income (loss) before minority interest                  | 2,880                                       | 37,031                               | (5,048)             | 34,863                        |
| Minority interest                                       |   | 6,874                                |                     | 6,874                         |
| Net income (loss)                                       | 2,880                                       | 43,905                               | (5,048)             | 41,737                        |

|   | <b>Nine Months Ended September 30, 2005</b> |                                      |                     |                               |
|---|---|--------------------------------------|---------------------|-------------------------------|
|   | <b>Restricted<br/>Group</b>                 | <b>Unrestricted<br/>Subsidiaries</b> | <b>Eliminations</b> | <b>Consolidated<br/>Group</b> |
| Revenues                                | 200,516                                     | 175,914                              |                     | 376,430                       |
| Operating costs                         | 158,384                                     | 152,939                              |                     | 311,323                       |
| Operating depreciation and amortization | 17,431                                      | 20,771                               | 660                 | 38,862                        |



Edgar Filing: MERCER INTERNATIONAL INC. - Form 10-Q

|  |          |           |         |           |
|--|----------|-----------|---------|-----------|
| General and administrative                     | 15,559   | 6,840     |         | 22,399    |
| (Sale) purchase of emission allowances         | (4,402)  | (7,951)   |         | (12,353)  |
|  | 186,972  | 172,599   | 660     | 360,231   |
| Income (loss) from operations                  | 13,544   | 3,315     | (660)   | 16,199    |
| Other income (expense) Interest expense        | (23,918) | (41,351)  | 1,949   | (63,320)  |
| Investment income                              | 2,313    | 1,230     | (1,949) | 1,594     |
| Unrealized foreign exchange loss on debt       | (1,591)  |           |         | (1,591)   |
| Derivative financial instruments, net          | (494)    | (69,765)  |         | (70,259)  |
| Impairment of investments                      | (1,699)  |           |         | (1,699)   |
| Total other expense                            | (25,389) | (109,886) |         | (135,275) |
| Loss before income taxes and minority interest | (11,845) | (106,571) | (660)   | (119,076) |
| Income tax (provision) benefit                 | (7,867)  | 22,494    |         | 14,627    |
| Loss before minority interest                  | (19,712) | (84,077)  | (660)   | (104,449) |
| Minority interest                              |          | 17,076    |         | 17,076    |
| Net loss                                       | (19,712) | (67,001)  | (660)   | (87,373)  |

FORM 10-Q  
 QUARTERLY REPORT PAGE 22

---

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

**Combined Condensed Statement of Operations**

|   | <b>Three Months Ended September 30, 2006</b> |                                      |                     |                               |
|---|--|--------------------------------------|---------------------|-------------------------------|
|   | <b>Restricted<br/>Group</b>                  | <b>Unrestricted<br/>Subsidiaries</b> | <b>Eliminations</b> | <b>Consolidated<br/>Group</b> |
| Revenues  | 95,908                                       | 80,672                               | (1,395)             | 175,185                       |
| Operating costs   | 65,705                                       | 51,689                               | 4,434               | 121,828                       |
| Operating depreciation and amortization                 | 6,383  | 7,176                                |                     | 13,559                        |
| General and administrative expenses                     | 3,289  | 2,464                                |                     | 5,753                         |
| Gain on sale of assets                                  |  | (359)                                |                     | (359)                         |
|   | 75,377                                       | 60,970                               | 4,434               | 140,781                       |
| Income (loss) from operations                           | 20,531                                       | 19,702                               | (5,829)             | 34,404                        |
| Other income (expense)                                  |  |                                      |                     |                               |
| Interest expense  | (8,160)                                      | (14,827)                             | 895                 | (22,092)                      |
| Investment income                                       | 1,143  | (369)                                | 311                 | 1,085                         |
| Foreign exchange loss on debt                           | (704)  |                                      |                     | (704)                         |
| Derivative financial instruments, net                   |  | (14,473)                             |                     | (14,473)                      |
| Total other (expense) income                            | (7,721)                                      | (29,669)                             | 1,206               | (36,184)                      |
| Income (loss) before income taxes and minority interest | 12,810                                       | (9,967)                              | (4,623)             | (1,780)                       |
| Income tax provision                                    | (1,189)                                      | 3,913                                | (192)               | 2,532                         |
| Income (loss) before minority interest                  | 11,621                                       | (6,054)                              | (4,815)             | 752                           |
| Minority interest                                       |  | 5,976                                |                     | 5,976                         |
| Net income (loss)                                       | 11,621                                       | (78)                                 | (4,815)             | 6,728                         |

|   | <b>Three Months Ended September 30, 2005</b> |                                      |                     |                               |
|---|--|--------------------------------------|---------------------|-------------------------------|
|   | <b>Restricted<br/>Group</b>                  | <b>Unrestricted<br/>Subsidiaries</b> | <b>Eliminations</b> | <b>Consolidated<br/>Group</b> |
| Revenues                                | 86,100                                       | 62,828                               |                     | 148,928                       |
| Operating costs                         | 71,124                                       | 54,915                               |                     | 126,039                       |
| Operating depreciation and amortization | 6,602  | 7,155                                | 222                 | 13,979                        |
| General and administrative              | 4,482  | 2,601                                |                     | 7,083                         |

Edgar Filing: MERCER INTERNATIONAL INC. - Form 10-Q

|   |         |          |       |          |
|---|---------|----------|-------|----------|
| (Sale) purchase of emission allowances                  | (2,267) | (3,798)  |       | (6,065)  |
|   | 79,941  | 60,873   | 222   | 141,036  |
| Income from operations                                  | 6,159   | 1,955    | (222) | 7,892    |
| Other income (expense)                                  |         |          |       |          |
| Interest expense  | (7,987) | (14,780) | 856   | (21,911) |
| Investment income                                       | 1,016   | 453      | (856) | 613      |
| Unrealized foreign exchange gain on debt                | 5,918   |          |       | 5,918    |
| Derivative financial instruments, net                   | (31)    | 3,082    |       | 3,051    |
| Total other income (expense)                            | (1,084) | (11,245) |       | (12,329) |
| Income (loss) before income taxes and minority interest | 5,075   | (9,290)  | (222) | (4,437)  |
| Income tax (provision) benefit                          | (3,091) | (3,694)  |       | (6,785)  |
| Income (loss) before minority interest                  | 1,984   | (12,984) | (222) | (11,222) |
| Minority interest                                       |         | 5,667    |       | 5,667    |
| Net income (loss)                                       | 1,984   | (7,317)  | (222) | (5,555)  |

FORM 10-Q  
 QUARTERLY REPORT PAGE 23

---

**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 10. Reorganization and Divestment of Interests in Paper Assets**

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. Only the cash portion of the consideration appears on the consolidated condensed statements of cash flows.

**Note 11. Subsequent Event**

Subsequent to September 30, 2006, the Company increased its interest in the Stendal mill to 70.6% by acquiring a 7% minority interest therein for 8.1 million, of which 6.7 million was paid by a note that, at its election, the Company can satisfy in shares of its common stock.

FORM 10-Q

QUARTERLY REPORT PAGE 24

---

## 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, 2006, unless otherwise stated; (iv) all references to monetary amounts are to Euros, unless otherwise stated; (v) € refers to Euros and C\$ refers to Canadian dollars; and (vi) ADMTs refers to air-dried metric tonnes.

The following discussion and analysis of our results of operations and financial condition for the nine months ended September 30, 2006 should be read in conjunction with our consolidated 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, 2005 filed with the Securities and Exchange Commission (the SEC). Certain reclassifications have been made to the prior period financial statements to conform with the current period presentation.

### Results of Operations

#### *Nine Months Ended September 30, 2006 Compared to Nine Months Ended September 30, 2005*

Selected sales data for the nine months ended September 30, 2006 and 2005 is as follows:

|  | <b>Nine Months Ended September<br/>30,</b> |             |
|--|--|-------------|
|  | <b>2006</b>                                | <b>2005</b> |
|  | <b>(ADMTs)</b>                             |             |
| <b>Sales Volume by Product Class</b>   |  |             |
| Pulp sales volume by mill:             |  |             |
| Rosenthal                              | 229,891                                    | 241,572     |
| Stendal                                | 422,272                                    | 243,267     |
| Celgar <sup>(1)</sup>                  | 342,404                                    | 325,419     |
| Total pulp sales volume <sup>(2)</sup> | 994,567                                    | 810,258     |
| Paper sales volume                     | 42,655 <sup>(3)</sup>                      | 51,406      |
| Total sales volume <sup>(2)</sup>      | 1,037,222                                  | 861,664     |

**(in thousands)**

### Revenues by Product Class

|  |                       |         |
|--|-----------------------|---------|
| Pulp revenues by mill:                             |                       |         |
| Rosenthal  | 105,812               | 100,967 |
| Stendal  | 188,546               | 127,637 |
| Celgar <sup>(1)</sup>                              | 157,328               | 97,458  |
| Total pulp revenues <sup>(2)</sup>                 | 451,686               | 326,062 |
| Paper revenues                                     | 43,465 <sup>(3)</sup> | 46,995  |
| Total pulp and paper sales revenues <sup>(2)</sup> | 495,151               | 373,057 |
| Third party transportation revenues                | 5,802                 | 3,373   |
| Total sales revenues                               | 500,953               | 376,430 |

(1)

The results of the Celgar pulp mill are included from the date of its acquisition on February 14, 2005.

- (2) Excluding intercompany sales volumes of 12,631 and 10,651 ADMTs of pulp and intercompany net sales revenues of approximately 5.8 million and 4.8 million in the nine months ended September 30, 2006 and 2005, respectively.
- (3) In August 2006, we sold our Heidenau paper mill.

FORM 10-Q  
QUARTERLY REPORT PAGE 25

---

Selected production data for the nine months ended September 30, 2006 and 2005 is as follows:

| <b>Production by Product Class</b> | <b>Nine Months Ended September</b> |             |
|------------------------------------|------------------------------------|-------------|
|                                    | <b>2006</b>                        | <b>2005</b> |
|                                    | <b>30,</b>                         |             |
|                                    | <b>(ADMTs)</b>                     |             |
| Pulp production by mill:           |                                    |             |
| Rosenthal                          | 227,645                            | 240,665     |
| Stendal                            | 414,787                            | 357,814     |
| Celgar <sup>(1)</sup>              | 330,978                            | 289,868     |
| Total pulp production              | 973,410                            | 888,347     |
| Paper production                   | 44,313 <sup>(2)</sup>              | 50,001      |
| Total production                   | 1,017,723                          | 938,348     |

(1) The results of the Celgar pulp mill are included from the date of its acquisition on February 14, 2005.

(2) In August 2006, we sold our Heidenau paper mill.

Revenues for the nine months ended September 30, 2006 increased to 501.0 million from 376.4 million in the comparative period of 2005, primarily due to higher pulp prices and sales from our Celgar and Stendal pulp mills. Pulp sales by volume increased to 994,567 ADMTs in the first nine months of 2006 from 810,258 ADMTs in the comparative period of 2005.

Cost of sales and general, administrative and other expenses in the first nine months of 2006 increased to 444.2 million from 360.2 million in the comparative period of 2005, primarily as a result of higher sales from our Celgar and Stendal mills.

For the first nine months of 2006, revenues from our pulp operations increased to 457.2 million from 329.4 million in the same period a year ago. List prices for NBSK pulp in Europe were approximately 533 (\$663) per ADMT in the first nine months of 2006, approximately 484 (\$611) per ADMT in the first nine months of 2005 and approximately 556 (\$708) per ADMT in the third quarter of 2006.

Mill net pulp sales realizations increased to 454 per ADMT on average in the first nine months of 2006 from 402 per ADMT in the first nine months of 2005, primarily as a result of higher pulp prices.

During the current period, we took an aggregate of 50 days scheduled maintenance and strategic capital expenditure downtime at our pulp mills, including 21 days at our Rosenthal mill, 16 days at our Stendal mill and 13 days at our Celgar mill. During the downtime at our Rosenthal mill, we completed the installation of a new brownstock washer at a cost of approximately 9.7 million, which is expected to further improve pulp quality and lower chemical costs and effluents. During the comparative period of 2005, our pulp mills took approximately 44 days maintenance and strategic capital expenditure downtime.

Cost of sales and general, administrative and other expenses for the pulp operations increased to 405.9 million in the first nine months of 2006 from 311.3 million in the comparative period of 2005 primarily as a result of higher sales from our Celgar and Stendal mills.

Fiber costs at our German pulp mills increased by approximately 7% in the first nine months of 2006 versus the same period of 2005. This resulted from lower availability because of severe winter conditions in Germany and central Europe, which caused sawmillers and log harvesters to curtail operations in the first part of the year and increased competition for fiber primarily from renewable energy

FORM 10-Q

QUARTERLY REPORT PAGE 26

---



operations. The increase in worldwide energy prices has made projects generating energy from renewable sources such as wood residuals more viable in Europe. As a result, there has been increased fiber demand and competition in our fiber base. In the first nine months of 2006, average fiber costs at our Celgar mill decreased by approximately 10% versus the same period of 2005, primarily because of fluctuations in regional wood chip availability. We expect that reduced fiber availability during the winter harvesting season will result in upward pressure on fiber prices into the last part of 2006 and into the first part of 2007.

In the first nine months of 2006, we recorded a contribution to income from operations of \$13.2 million resulting from the sale of emission allowances compared to \$12.4 million in the comparative period of 2005.

Depreciation for the pulp operations increased to \$41.6 million in the first nine months of 2006, from \$37.4 million in the first nine months of 2005, primarily as a result of the inclusion of depreciation for the Celgar mill for the full period.

For the first nine months of 2006, our pulp operations generated operating income of \$57.5 million, versus operating income of \$22.9 million in the same period of 2005, primarily due to improving pulp markets and the higher operating income at our Celgar pulp mill, partially offset by maintenance and strategic capital expenditure downtime at our pulp mills. The overall strength of the Canadian dollar versus the U.S. dollar negatively impacted our Celgar mill's results. In August 2006, we disposed of our equity interest in the Heidenau paper mill and in a Swiss specialty paper mill for cash proceeds of \$5.0 million and a secured note of \$5.0 million. We recorded a gain of \$0.4 million on the transaction. We currently operate one paper mill at Fährbrücke, that we do not consider part of our core operations. We are continuing to explore and consider strategic options for such mill, including a sale, closure or divestiture thereof.

Revenues from our paper operations in the first nine months of 2006 decreased to \$43.8 million from \$47.0 million in the same period of last year, primarily as a result of the sale of our Heidenau paper mill in August 2006.

Cost of sales and general, administrative and other expenses for the paper operations in the first nine months of 2006 decreased to \$43.1 million from \$49.2 million in the comparative period of 2005.

In the first nine months of 2006, our paper operations generated operating income of \$0.6 million, compared to an operating loss of \$2.2 million in the first nine months of 2005.

In the first nine months of 2006, income from operations increased to \$56.8 million from \$16.2 million in the same period last year, primarily as a result of higher pulp prices and improved results from our Celgar pulp mill.

Interest expense in the first nine months of 2006 increased to \$68.1 million from \$63.3 million in the year ago period, primarily due to higher borrowing costs relating to the Stendal mill.

Stendal entered into certain foreign currency derivatives to swap all 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 net unrealized non-cash holding gain of \$76.3 million before

FORM 10-Q

QUARTERLY REPORT PAGE 27

---

minority interests upon the marked to market valuation of such derivatives that were outstanding at the end of the current period, compared to a net non-cash holding loss of \$67.8 million before minority interests upon the marked to market valuation of our outstanding derivatives in the comparative period of 2005. In the first nine months of 2006, we recorded a realized loss of \$5.2 million compared to a realized loss of \$2.5 million in the comparative period of 2005 primarily from the sale of currency forwards.

In the first nine months of 2006, minority interest, representing the two minority shareholders' proportionate interest in the Stendal mill's losses for the period, was \$6.9 million, compared to \$17.1 million in the first nine months of 2005. Subsequent to September 30, 2006, we increased our ownership in Stendal to 70.6% by acquiring a 7% minority interest therein for \$8.1 million, of which \$6.7 million was paid by a note that, at our election, we can satisfy in shares of our common stock.

We reported net income for the first nine months of 2006 of \$41.7 million, or \$1.26 per basic and \$1.05 per diluted share, which reflected a net realized and unrealized gain of \$71.0 million on our interest rate and currency derivatives, an unrealized non-cash foreign exchange gain on our long-term debt of \$11.5 million and improved pulp markets. In the first nine months of 2005, we reported a net loss of \$87.4 million, or \$2.86 per basic and diluted share, which reflected interest expense related to our Stendal mill of \$41.0 million, the realized and unrealized net losses on our currency and interest rate derivatives of \$70.1 million, the unrealized non-cash foreign exchange loss on our long-term debt of \$1.6 million, and the non-cash impairment charge of \$1.7 million relating to investments, partially offset by a non-cash benefit for income taxes of \$14.6 million.

We generated Operating EBITDA of \$99.1 million and \$55.1 million in the nine months ended September 30, 2006 and 2005, respectively. Operating EBITDA is defined as income (loss) from operations plus depreciation and amortization and non-recurring capital asset impairment charges.

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

Operating EBITDA does not reflect the impact of a number of items that affect our net income (loss), 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 (loss) or income (loss) from operations as a measure of performance, nor as an alternative to net cash from operating activities as a measure of liquidity.

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

FORM 10-Q

QUARTERLY REPORT PAGE 28

---

minority interests on our Stendal NBSK pulp mill operations; (v) the impact of realized or marked to market changes in our derivative positions, which can be substantial; and (vi) the impact of impairment charges against our investments or assets. Because of these limitations, Operating EBITDA should only be considered as a supplemental performance measure and should not be considered as a measure of liquidity or cash available to us to invest in the growth of our business. See the Statement of Cash Flows set out in our consolidated financial statements included herein. Because all companies do not calculate Operating EBITDA in the same manner, Operating EBITDA as calculated by us may differ from Operating EBITDA or EBITDA as calculated by other companies. We compensate for these limitations by using Operating EBITDA as a supplemental measure of our performance and relying primarily on our GAAP financial statements.

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

|   | <b>Nine Months Ended<br/>September 30,</b> |                           |
|---|--|---------------------------|
|   | <b>2006</b>                                | <b>2005<sup>(1)</sup></b> |
|   | <b>(in thousands)</b>                      |                           |
| Net income (loss)                                 | 41,737                                     | (87,373)                  |
| Minority interest                                 | (6,874)                                    | (17,076)                  |
| Income taxes (benefit)                            | 40,388                                     | (14,627)                  |
| Interest expense                                  | 68,129                                     | 63,320                    |
| Investment income                                 | (4,096)                                    | (1,594)                   |
| Foreign exchange (gain) loss on debt              | (11,469)                                   | 1,591                     |
| Derivative financial instruments, net (gain) loss | (71,032)                                   | 70,259                    |
| Impairment of investments                         |  | 1,699                     |
| Income from operations                            | 56,783                                     | 16,199                    |
| Add: Depreciation and amortization                | 42,341                                     | 38,862                    |
| Operating EBITDA                                  | 99,124                                     | 55,061                    |

(1) The results of the Celgar pulp mill are included from the date of its acquisition on February 14, 2005.

***Three Months Ended September 30, 2006 Compared to Three Months Ended September 30, 2005***

Selected sales data for the three months ended September 30, 2006 and 2005 is as follows:

|                                      | <b>Three Months Ended September<br/>30,</b> |             |
|--------------------------------------|---|-------------|
|                                      | <b>2006</b>                                 | <b>2005</b> |
|                                      | <b>(ADMTs)</b>                              |             |
| <b>Sales Volume by Product Class</b> |   |             |
| Pulp sales volume by mill:           |   |             |
| Rosenthal                            | 80,655                                      | 86,772      |

Edgar Filing: MERCER INTERNATIONAL INC. - Form 10-Q

|  |                       |         |
|--|-----------------------|---------|
| Stendal                                | 144,864               | 120,431 |
| Celgar                                 | 112,682               | 125,079 |
| Total pulp sales volume <sup>(1)</sup> | 338,201               | 332,282 |
| Paper sales volume                     | 10,571 <sup>(2)</sup> | 16,928  |
| Total sales volume <sup>(1)</sup>      | 348,772               | 349,210 |

FORM 10-Q  
QUARTERLY REPORT PAGE 29

---

|  | <b>Three Months Ended September</b> |             |
|--|-------------------------------------|-------------|
|  | <b>30,</b>                          |             |
|  | <b>2006</b>                         | <b>2005</b> |
|  | <b>(in thousands)</b>               |             |
| <b>Revenues by Product Class</b>                   |                                     |             |
| Pulp revenues by mill:                             |                                     |             |
| Rosenthal  | 38,419                              | 36,463      |
| Stendal  | 68,004                              | 46,764      |
| Celgar   | 56,494                              | 48,978      |
| <br>   |                                     |             |
| Total pulp revenues <sup>(1)</sup>                 | 162,917                             | 132,205     |
| Paper revenues                                     | 10,022 <sup>(2)</sup>               | 15,532      |
| <br>   |                                     |             |
| Total pulp and paper sales revenues <sup>(1)</sup> | 172,939                             | 147,737     |
| <br>   |                                     |             |
| Third party transportation revenues                | 2,246                               | 1,191       |
| <br>   |                                     |             |
| Total sales revenues                               | 175,185                             | 148,928     |

(1) Excluding intercompany sales volumes of 2,774 and 3,057 ADMTs of pulp and intercompany net sales revenues of approximately 1.3 million and 1.3 million in the three months ended September 30, 2006 and 2005, respectively.

(2) In August 2006, we sold our Heidenau paper mill.

Selected production data for the three months ended September 30, 2006 and 2005 is as follows:

|                                    | <b>Three Months Ended September</b> |             |
|------------------------------------|-------------------------------------|-------------|
|                                    | <b>30,</b>                          |             |
|                                    | <b>2006</b>                         | <b>2005</b> |
|                                    | <b>(ADMTs)</b>                      |             |
| <b>Production by Product Class</b> |                                     |             |

|                          |                       |         |
|--------------------------|-----------------------|---------|
| Pulp production by mill: |                       |         |
| Rosenthal                | 84,115                | 83,350  |
| Stendal                  | 144,195               | 126,202 |
| Celgar                   | 118,890               | 118,035 |
| Total pulp production    | 347,200               | 327,587 |
| Paper production         | 10,711 <sup>(1)</sup> | 16,064  |
| Total production         | 357,911               | 343,651 |

(1) In August 2006, we sold our Heidenau paper mill.

Revenues for the three months ended September 30, 2006 increased to 175.2 million from 148.9 million in the comparative period of 2005, primarily due to higher pulp prices and sales from our Stendal pulp mill. Pulp sales by volume increased to 338,201 ADMTs in the third quarter of 2006 from 332,282 ADMTs in the comparative period of 2005.

Cost of sales and general, administrative and other expenses in the third quarter of 2006 decreased to 140.8 million from 141.0 million in the comparative period of 2005.

For the third quarter of 2006, revenues from our pulp operations increased to 164.9 million from 133.4 million in the same period a year ago. List prices for NBSK pulp in Europe were approximately 556 (\$708) in the third quarter of 2006, compared to approximately 476 (\$580) per ADMT in the third quarter of 2005.

Mill net pulp sales realizations increased to 482 per ADMT on average in the third quarter of 2006 from 398 per ADMT in the third quarter of 2005, primarily as a result of higher pulp prices.

Cost of sales and general, administrative and other expenses for the pulp operations increased to 132.8 million in the third quarter of 2006 from 125.5 million in the comparative period of 2005, primarily as a result of the absence of the sale of emission allowances and higher sales from our Stendal mill.

FORM 10-Q

QUARTERLY REPORT PAGE 30

---

Fiber costs at our German pulp mills increased by approximately 10% in the third quarter of 2006 versus the same period of 2005 primarily because of increased demand for wood residuals. In the third quarter of 2006, average fiber costs at our Celgar mill increased by approximately 6% versus the same quarter of 2005, primarily because of fluctuations in regional wood chip availability. We expect that reduced fiber availability during the winter harvesting season will result in continued upward pressure on fiber prices into the last part of 2006 and into the first part of 2007. In the third quarter of 2006, we recorded a contribution to income from operations of nil resulting from the sale of emission allowances compared to 6.1 million in the comparative quarter of 2005.

Depreciation for the pulp operations increased to 13.4 million in the third quarter of 2006, from 13.3 million in the comparative quarter of 2005.

For the third quarter of 2006, our pulp operations generated operating income of 33.8 million, versus operating income of 9.2 million, primarily as a result of higher pulp prices and improved operating results at our Celgar pulp mill.

In August 2006, we disposed of our equity interest in the Heidenau paper mill and in a Swiss specialty paper mill for cash proceeds of 5.0 million and a secured note of 5.0 million. We recorded a gain of 0.4 million on the transaction. We currently operate one paper mill at Fährbrücke, that we do not consider part of our core operations. We are continuing to explore and consider strategic options for such mill, including a sale, closure or divestiture thereof. Revenues from our paper operations were 10.3 million in the current quarter, compared to 15.5 million in same quarter of last year.

Cost of sales and general, administrative and other expenses for the paper operations in the third quarter of 2006 decreased to 10.4 million from 16.6 million in the comparative quarter of 2005.

For the third quarter of 2006, our paper operations generated an operating loss of 0.3 million, compared to an operating loss of 1.1 million in the third quarter of 2005.

In the third quarter of 2006, we had income from operations of 34.4 million, compared to 7.9 million in the same quarter last year. Interest expense in the third quarter of 2006 increased to 22.1 million from 21.9 million in the year ago period.

Stendal entered into certain foreign currency derivatives to swap all 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. The weakening of the U.S. dollar versus the Euro was more than offset by a recent reduction in long-term interest rates, leading to a net unrealized non-cash holding loss of 14.5 million before minority interests upon the marked to market valuation of such derivatives that were outstanding at the end of the current quarter, compared to a net realized and unrealized non-cash holding gain of 3.1 million before minority interests upon the marked to market valuation of our outstanding derivatives in the comparative quarter of 2005.

In the third quarter of 2006, minority interest, representing the two minority shareholders' proportionate interest in the Stendal mill, was 6.0 million, compared to 5.7 million in the third quarter of 2005.

FORM 10-Q

QUARTERLY REPORT PAGE 31

---

We reported net income for the three months ended September 30, 2006 of 6.7 million, or 0.20 per basic and 0.19 per diluted share, which included an aggregate of 15.2 million unrealized losses on our outstanding derivatives and a foreign exchange loss on our long-term debt. In the third quarter of 2005, we reported a net loss of 5.6 million, or 0.17 per basic and diluted share, which reflected the inclusion of interest expense related to our Stendal mill of 14.7 million and the net realized and unrealized gain of 3.1 million on our interest rate and currency derivatives and the unrealized non-cash foreign exchange gain on our long-term debt of 5.9 million.

We generated Operating EBITDA of 48.0 million and 21.9 million in the three months ended September 30, 2006 and 2005, 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 2006 for additional information relating to Operating EBITDA.

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

|   | <b>Three Months Ended</b> |             |
|---|---------------------------|-------------|
|   | <b>September 30,</b>      |             |
|   | <b>2006</b>               | <b>2005</b> |
|   | <b>(in thousands)</b>     |             |
| Net income (loss)                                 | 6,728                     | (5,555)     |
| Minority interest                                 | (5,976)                   | (5,667)     |
| Income taxes (benefit)                            | (2,532)                   | 6,785       |
| Interest expense                                  | 22,092                    | 21,911      |
| Investment income                                 | (1,085)                   | (613)       |
| Foreign exchange (gain) loss on debt              | 704                       | (5,918)     |
| Derivative financial instruments, net (gain) loss | 14,473                    | (3,051)     |
| Income from operations                            | 34,404                    | 7,892       |
| Add: Depreciation and amortization                | 13,559                    | 13,979      |
| Operating EBITDA                                  | 47,963                    | 21,871      |

### **Liquidity and Capital Resources**

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

|                                | <b>As at</b>           | <b>As at</b>        |
|--------------------------------|------------------------|---------------------|
|                                | <b>September 30,</b>   | <b>December 31,</b> |
|                                | <b>2006</b>            | <b>2005</b>         |
|                                | <b>(in thousands)</b>  |                     |
| <b>Financial Position</b>      |                        |                     |
| Cash and cash equivalents      | 69,373                 | 83,547              |
| Working capital <sup>(1)</sup> | 84,366                 | 111,195             |
| Property, plant and equipment  | 994,805                | 1,024,662           |
| Total assets                   | 1,336,345              | 1,393,816           |
| Long-term liabilities          | 996,278 <sup>(2)</sup> | 1,104,746           |
| Shareholders' equity           | 195,843                | 148,743             |

(1) Does not include approximately 8.7 million of



government grants in 2006, which we expect to receive in 2006, and approximately 65.9 million of government grants in 2005, all of which has been received, related to the Stendal mill from German federal and state governments.

- (2) Includes 8.6 million outstanding under the revolving credit facility for the Celgar mill.

At September 30, 2006, our cash and cash equivalents were 69.4 million, compared to 83.5 million at December 31, 2005.

FORM 10-Q

QUARTERLY REPORT PAGE 32

---

During the third quarter of 2006, restricted cash at Stendal decreased by 9.5 million to 57.0 million due to the final drawdown on the shareholder standby loan. The restricted cash at September 30, 2006 is a debt service security or reserve equal to approximately one year's worth of Stendal's scheduled principal and interest payments under the Stendal Loan facility. As this debt service account secures Stendal's obligations under the Stendal Loan Facility, it is recorded as a long-term asset.

Our reduction in working capital at September 30, 2006 compared to December 31, 2005 of approximately 26.8 million resulted principally from a build-up of 32.4 million in the restricted cash in the Stendal debt service account, which is classified as a long-term asset, and the reclassification as current liabilities of certain principal payments on the Stendal Loan Facility that mature within one year.

At September 30, 2006, we qualified for investment grants related to the Stendal mill totaling approximately 8.7 million from the federal and state governments of Germany, which we expect to receive in the fourth quarter of 2006. These grants, when received, will be applied to repay the amounts drawn under the current portion of a dedicated tranche of the Stendal Loan Facility. Under our accounting policies, we do not record these grants until they are received. The grants are not reported in our income and reduce the cost basis of the assets purchased when they are received.

As at September 30, 2006, we had not drawn any amount under the 40.0 million Rosenthal revolving term credit facility and had drawn down approximately 8.6 million of the C\$40 million Celgar revolving credit facility. We expect to meet our interest and debt service expenses and the working and maintenance capital requirements for our operations (other than at Stendal) from cash flow from operations, cash on hand and the two revolving working capital facilities for the Rosenthal and Celgar mills.

We expect to meet the capital requirements for the Stendal mill, including potential losses during ramp up, interest and principal service expenses through cash on hand, cash flow from operations, shareholder advances already made to Stendal, the Stendal Loan Facility (which includes a revolving working capital tranche and a debt service reserve account) and the receipt of government grants.

#### ***Operating Activities***

Operating activities in the first nine months of 2006 provided cash of 31.9 million, compared to using cash of 5.6 million in the comparative period of 2005. An increase in receivables due primarily to higher sales used cash of 14.9 million in the first nine months of 2006, compared to an increase in receivables using cash of 20.4 million in the comparative period of 2005. A decrease in inventories due primarily to a reduction in raw materials and finished goods at the Stendal mill provided cash of 11.9 million in the first nine months of 2006, compared to using cash of 9.6 million in the comparative period of 2005. A decrease in accounts payable and accrued expenses used cash of 0.1 million in the first nine months of 2006, compared to an increase that provided cash of 33.8 million in the comparative period of 2005.

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

FORM 10-Q

QUARTERLY REPORT PAGE 33

---

***Investing Activities***

Investing activities in the nine months ended September 30, 2006 used cash of \$44.4 million, compared to the nine months ended September 30, 2005 when investing activities used cash of \$97.2 million. In the nine months ended September 30, 2006, a drawdown under a tranche of the Stendal project financing facility to increase our restricted cash in the Stendal debt service reserve account used cash of \$25.4 million versus a decrease in restricted cash providing cash of \$60.7 million in the comparative period of 2005.

***Financing Activities***

Financing activities used cash of \$1.1 million in the nine months ended September 30, 2006, compared to the first nine months of 2005 when, in connection with the acquisition of the Celgar pulp mill, financing activities, including the issuance of common stock and senior notes, provided cash of \$134.2 million.

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 2006.

***Capital Resources***

In addition to our revolving credit facilities for the Rosenthal and Celgar mills and the revolving working capital tranche of the Stendal Loan Facility, respectively, 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 our paper 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.

***Stendal Pulp Mill EPC Contract***

The Stendal mill was constructed under a \$716.0 million fixed price turn-key EPC contract between Stendal and RWE, as head contractor. The contractor's obligations under the contract are guaranteed by its parent company.

FORM 10-Q

QUARTERLY REPORT PAGE 34

---

Pursuant to the EPC contract, each department of the mill is tested on a stand-alone basis for compliance with its design specifications. Under the EPC contract, RWE warrants conformity to specifications, compliance with permits and laws, suitability for intended use, compliance with performance requirements and against defects in construction for a stipulated period, subject to extension in certain circumstances. The testing and warranty are highly technical and include detailed design and performance specifications. Some of the prescribed testing was unsatisfactory to Stendal. As is common in large greenfield projects like the Stendal mill, Stendal made a significant number of claims, including rights to penalties and/or liquidated damages against the contractor under the EPC contract prior to the expiry of the applicable warranty claim period in September 2006. Many claims are highly technical and relate to, among other things, design and performance specifications and reliability, as well as penalties in regards to delays. Stendal and the contractor have agreed to try to work to resolve such outstanding claims by late December 2006 without either party seeking recourse to arbitration or other similar legal remedies under the EPC contract. Currently, we cannot predict with any certainty which claims of Stendal the contractor may accept, the amount, if any, of any recoveries associated therewith or the final determination of such claims whether through further work and retesting by the contractor, legal proceedings, negotiation or other settlement.

#### **Foreign Currency**

Effective January 1, 2002, we changed our reporting currency from the U.S. dollar to the Euro as a significant majority of our business transactions are originally denominated in Euros. By adopting the Euro, most cumulative foreign currency translation losses were eliminated. However, we hold certain assets and liabilities in U.S. dollars, Swiss francs and in 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, 2006, we reported a net 4.4 million foreign exchange translation gain and, as a result, the cumulative foreign exchange translation gain increased to 20.0 million at September 30, 2006 from 15.6 million at December 31, 2005.

Based upon the exchange rate at September 30, 2006, the U.S. dollar decreased by approximately 5% in value against the Euro since September 30, 2005. 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 . As at and during the nine months ended September 30, 2006, the Restricted Group was comprised of Mercer Inc., certain holding subsidiaries, Rosenthal and Celgar. During

FORM 10-Q

QUARTERLY REPORT PAGE 35

---

the nine months ended September 30, 2005 and as at December 31, 2005, the Restricted Group was comprised of Mercer Inc., certain holding subsidiaries, Rosenthal and the Celgar mill from February 14, 2005, the date of the acquisition of the mill. The Restricted Group excludes our paper operations and our Stendal mill.

The following is a discussion of the results of operations and financial condition of the Restricted Group. For further information regarding the operating results of the Rosenthal and Celgar mills, see Note 5 of our quarterly financial statements included herein. For further information regarding the Restricted Group including, without limitation, a reconciliation to our consolidated results of operations, see Note 9 of our quarterly financial statements included herein.

***Restricted Group Results Nine Months Ended September 30, 2006 Compared to Nine Months Ended September 30, 2005***

Total revenues for the Restricted Group for the nine months ended September 30, 2006 increased to 265.5 million from 200.5 million in the comparative period of 2005, primarily because of higher pulp sales from the Celgar mill and higher prices. Pulp sales realizations for the Restricted Group were 460 per ADMT on average in the nine months ended September 30, 2006 and 409 per ADMT in the comparative period of 2005. The increase in NBSK pulp prices was partially offset by the strength of the Canadian dollar versus the U.S. dollar during the current period.

Costs of sales and general, administrative and other expenses for the Restricted Group in the nine months ended September 30, 2006 increased to 244.7 million from 187.0 million in the comparative period of 2005 primarily as a result of higher sales.

During the current period, we took an aggregate of 34 days scheduled maintenance and strategic capital expenditure downtime at the Rosenthal and Celgar mills, including 21 days at our Rosenthal mill and 13 days at our Celgar mill. During the downtime at our Rosenthal mill, we completed the installation of a new brownstock washer at a cost of approximately 9.7 million, which is expected to further improve pulp quality and lower chemical costs and effluents. During the comparative period of 2005, our Rosenthal and Celgar mills took approximately 13 days of maintenance and strategic capital expenditure downtime.

In the first nine months of 2006, we recorded income from operations of 3.7 million through the sale of emission allowances by our Rosenthal pulp mill, compared to 4.4 million in the same period of 2005. The market for emission allowances is relatively new and volatile. Based upon our activities to date, we currently estimate the Restricted Group's overall volume of emission allowance sales in the current year will be at or near the total volume sold by it for the full year in 2005.

On average, fiber costs at our Rosenthal pulp mill increased by approximately 11% in the first nine months of 2006 versus the same period of 2005. This resulted from lower availability because of severe winter conditions in Germany and central Europe, which caused sawmillers and log harvesters to curtail operations in the first part of the year and increased competition for fiber primarily from renewable energy operations. In the first nine months of 2006, average fiber costs at our Celgar mill decreased by approximately 10% versus the same period of 2005, primarily because of increased regional wood chip availability. We expect that reduced fiber availability during the winter harvesting season will result in upward pressure on fiber prices into the last part of 2006 and into the first part of 2007.

FORM 10-Q

QUARTERLY REPORT PAGE 36

---

Depreciation and amortization for the Restricted Group increased to 20.6 million in the current period from 17.4 million in the comparative period of 2005, primarily as a result of the inclusion of depreciation of the Celgar mill for the full period.

In the first nine months of 2006, the Restricted Group reported income from operations of 20.8 million, compared to 13.5 million in the first nine months of 2005, primarily as a result of a higher operating income at our Celgar mill. Interest expense for the Restricted Group in the nine months ended September 30, 2006 increased to 24.6 million from 23.9 million in the first nine months of 2005.

In the first nine months of 2006, the Restricted Group recorded a foreign exchange gain on debt of 11.5 million, compared to a loss of 1.6 million in the comparative period of 2005. In the first nine months of 2005, the Restricted Group reported a non-cash impairment charge of 1.6 million related to an investment in a venture company. For the nine months ended September 30, 2006, the Restricted Group reported net income of 2.9 million, compared to a loss of 19.7 million in the first nine months of 2005, primarily as a result of higher pulp prices and improved results at our Celgar mill.

The Restricted Group generated Operating EBITDA of 41.4 million and 31.0 million in the nine months ended September 30, 2006 and 2005, respectively. Operating EBITDA is defined as income (loss) from 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 and non-recurring capital asset impairment charges of 20.6 and 17.4 million to the income from operations of 20.8 million and 13.5 million for the nine months ended September 30, 2006 and 2005, 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, 2006 for additional information relating to such limitations and Operating EBITDA. The following table provides a reconciliation of net loss to income from operations and Operating EBITDA for the Restricted Group for the periods indicated:

|   | <b>Nine Months Ended<br/>September 30,<br/>2006                  2005<sup>(1)</sup></b> |          |
|---|---|----------|
|   | <b>(in thousands)</b>   |          |
| <b>Restricted Group<sup>(2)</sup></b>           |   |          |
| Net income (loss)                               | 2,880   | (19,712) |
| Income taxes                                    | 8,094   | 7,867    |
| Interest expense                                | 24,602  | 23,918   |
| Investment and other income                     | (3,262)   | (2,313)  |
| Derivative financial instruments, net           |   | 494      |
| Unrealized foreign exchange (gain) loss on debt | (11,469)  | 1,591    |
| Impairment of investments                       |   | 1,699    |
| Income from operations                          | 20,845  | 13,544   |
| Add: Depreciation and amortization              | 20,580  | 17,431   |
| Operating EBITDA                                | 41,425  | 30,975   |

(1) The results of the Celgar pulp mill are from the date of its acquisition on

February 14,  
2005.

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

FORM 10-Q  
QUARTERLY REPORT PAGE 37

---

***Restricted Group Results Three Months Ended September 30, 2006 Compared to Three Months Ended September 30, 2005***

Total revenues for the Restricted Group for the three months ended September 30, 2006 increased to 95.9 million from 86.1 million in the comparative period of 2005, primarily due to higher pulp prices and higher sales from our Celgar pulp mill. Pulp sales realizations for the Restricted Group were 491 per ADMT on average in the three months ended September 30, 2006 and 403 per ADMT in the comparative period of 2005.

Costs of sales and general, administrative and other expenses for the Restricted Group in the three months ended September 30, 2006 decreased to 75.4 million from 79.9 million in the comparative period of 2005, primarily as a result of lower operating costs at our Rosenthal mill.

During the current quarter we only took an aggregate of one day scheduled maintenance and strategic capital expenditure downtime at the Rosenthal and Celgar mills. During the same period of 2005, we had approximately two days of maintenance and strategic capital expenditure downtime at our Rosenthal and Celgar mills.

In the third quarter of 2006, we recorded a gain of nil million through the sale of emission allowances by our Rosenthal pulp mill, compared to 2.3 million in the same period of 2005.

On average, fiber costs at our Rosenthal pulp mill increased by approximately 13% in the third quarter of 2006 versus the same period of 2005. In the third quarter of 2006, average fiber costs at our Celgar mill increased by approximately 6% versus the same period of 2005 because of fluctuations in regional wood chip availability. We expect that reduced fiber availability during the winter harvesting season will result in continued upward pressure on fiber prices into the last part of 2006 and into the first part of 2007.

Depreciation and amortization for the Restricted Group decreased marginally to 6.4 million in the current quarter from 6.6 million in the comparative period of 2005.

In the third quarter of 2006, the Restricted Group reported income from operations of 20.5 million, compared to reported income from operations of 6.2 million in the third quarter of 2005, primarily as a result of higher prices and operating income at our Celgar mill.

Interest expense for the Restricted Group in the three months ended September 30, 2006 increased to 8.2 million from 8.0 million in the third quarter of 2005.

In the third quarter of 2006, the Restricted Group recorded a foreign exchange loss on debt of 0.7 million, compared to a gain of 5.9 million in the comparative period of 2005.

For the three months ended September 30, 2006, the net income reported by the Restricted Group was 11.6 million, compared to net income of 2.0 million in the third quarter of 2005, primarily as a result of improved operating income of our Celgar mill.

The Restricted Group generated Operating EBITDA of 26.9 million and 12.8 million in the three months ended September 30, 2006 and 2005, respectively. Operating EBITDA for the Restricted Group is calculated by adding depreciation and amortization and non-recurring capital asset impairment charges of 6.4 million and 6.6 million to the income from operations of

FORM 10-Q

QUARTERLY REPORT PAGE 38

---



20.5 million and 6.2 million for the three months ended September 30, 2006 and 2005, 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, 2006 for additional information relating to such limitations and Operating EBITDA. The following table provides a reconciliation of net loss to income from operations and Operating EBITDA for the Restricted Group for the periods indicated:

|   | <b>Three Months Ended<br/>September 30,<br/>2006                  2005</b> |         |
|---|--|---------|
|   | <b>(in thousands)</b>  |         |
| <b>Restricted Group<sup>(1)</sup></b>           |  |         |
| Net income                                      | 11,621   | 1,984   |
| Income taxes                                    | 1,189  | 3,091   |
| Interest expense                                | 8,160  | 7,987   |
| Investment and other expense (income)           | (1,143)  | (1,016) |
| Derivative financial instruments, net           |  | 31      |
| Unrealized foreign exchange (gain) loss on debt | 704  | (5,918) |
| <br>  |  |         |
| Income from operations                          | 20,531   | 6,159   |
| Add: Depreciation and amortization              | 6,383  | 6,602   |
| <br>  |  |         |
| Operating EBITDA                                | 26,914   | 12,761  |

(1) See Note 9 of the 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<br/>September<br/>30,<br/>2006</b> | <b>As at<br/>December 31,<br/>2005</b> |
|--|---|--|
|  | <b>(in thousands)</b>                       |  |
| <b>Restricted Group Financial Position<sup>(1)</sup></b> |   |  |
| Cash and cash equivalents                                | 37,381                                      | 48,790                                 |
| Working capital  | 85,717                                      | 93,312                                 |
| Property, plant and equipment                            | 424,205                                     | 404,151                                |
| Total assets   | 620,017                                     | 625,578                                |
| Long-term liabilities                                    | 341,816                                     | 364,596                                |
| Shareholders' equity                                     | 236,669                                     | 214,115                                |

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

At September 30, 2006, the Restricted Group had cash and cash equivalents of \$37.4 million, compared to \$48.8 million at December 31, 2005. At September 30, 2006, the Restricted Group had working capital of \$85.7 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, 2006, we had not drawn any amount under the Rosenthal

FORM 10-Q

QUARTERLY REPORT PAGE 39

---

revolving term credit facility and had drawn down approximately 8.6 million under the C\$40 million Celgar revolving credit facility.

**Critical Accounting Policies**

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

For information about our significant accounting policies, see our annual report on Form 10-K for the year ended December 31, 2005.

**Cautionary Statement Regarding Forward-Looking Information**

The statements in this report that are not reported financial results or other historical information are forward-looking statements within the meaning of the *Private Securities Litigation Reform Act of 1995*, as amended. These statements appear in a number of different places in this report and can be identified by words such as estimates, projects, expects, intends, believes, plans, or their negatives or other comparable words. Also look for discussions of strategies that involve risks and uncertainties. Forward-looking statements include statements regarding the outlook for our future operations, forecasts of future costs and expenditures, the evaluation of market conditions, the outcome of legal proceedings, the adequacy of reserves, or other business plans. You are cautioned that any such forward-looking statements are not guarantees and may involve risks and uncertainties. Our actual results may differ materially from those in the forward-looking statements due to risks facing us or due to actual facts differing from the 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, 2005. 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.

FORM 10-Q

QUARTERLY REPORT PAGE 40

---

## **Cyclical Nature of Business**

### *Revenues*

The pulp and paper 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. The markets for pulp and paper are highly competitive and are sensitive to cyclical changes in industry capacity and in the global economy, all of which can have a significant influence on selling prices and our earnings. Demand for pulp and paper products has historically been determined by the level of economic growth and has been closely tied to overall business activity. Although pulp prices have improved recently, we cannot predict the level of economic activity or growth in certain world markets or the impact of war, terrorist activity or other events on our markets and prices for our products.

Commencing in 2005, our German operations became subject to the European Union Emissions Trading Scheme pursuant to which our German mills were granted emission allowances. Emission allowances are granted based upon production volumes and the types of fuels consumed by the manufacturing facilities in Germany. Since then, we have benefited from the sale of emission allowances. However, the market for such sales is relatively new and volatile and we cannot predict the level of any sales thereafter.

### *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 for pulp production, and waste paper and pulp for paper production. Fiber costs are primarily affected by the supply of, and demand for, lumber and pulp, which are both highly cyclical in nature and can vary significantly by location. Recently, fiber demand in Europe has also increased because of demand from renewable energy projects and this has put upward pressure on prices for wood residuals such as wood chips. 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.

FORM 10-Q

QUARTERLY REPORT PAGE 41

---

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

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

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

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

In the first quarter of 2005, Stendal entered into currency swaps to convert a portion of its indebtedness under the Stendal Loan Facility from Euros into U.S. dollars and certain currency forwards. In April 2005, Stendal entered into a currency swap to convert the balance of its long-term indebtedness under the Stendal Loan Facility from Euros into U.S. dollars. During the first nine months of 2006, we recorded a net unrealized non-cash holding gain of \$76.3 million before minority interests upon the marked to market valuation of such derivatives compared to a net non-cash holding loss of \$67.8 million before minority interests upon the marked to market valuation of our outstanding derivatives in the comparative quarter of 2005. In the first nine months of 2006, we recorded a realized loss of \$5.2 million compared to a realized loss of \$2.5 million in the comparative period of 2005 primarily from the sale of currency forwards.

FORM 10-Q

QUARTERLY REPORT PAGE 42

---

**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.

FORM 10-Q

QUARTERLY REPORT PAGE 43

---

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

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

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, 2005.

**ITEM 6. EXHIBITS**

| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 10.1               | Share purchase agreement between MFC Industrial Holdings AG and Stendal Pulp Holding GmbH dated for reference the 18 <sup>th</sup> day of October 2006 |
| 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.

FORM 10-Q  
QUARTERLY REPORT PAGE 44

---



**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, 2006  
FORM 10-Q  
QUARTERLY REPORT PAGE 45