

MERCER INTERNATIONAL INC.

Form 10-Q

May 08, 2007

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

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2007
OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from _____ to _____
Commission File No.: 000-51826
MERCER INTERNATIONAL INC.
(Exact name of Registrant as specified in its charter)

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

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

Suite 2840, 650 West Georgia Street, Vancouver, British Columbia, Canada, V6B 4N8
(Address of office)

(604) 684-1099

(Registrant's telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the *Securities Exchange Act of 1934* during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES NO

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

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer

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

The Registrant had 36,254,027 shares of common stock outstanding as at May 7, 2007.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

**MERCER INTERNATIONAL INC.
CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED MARCH 31, 2007
(Unaudited)**

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

	March 31, 2007	December 31, 2006
ASSETS		
Current Assets		
Cash and cash equivalents	44,970	69,367
Receivables	97,454	75,022
Note receivable, current portion	5,814	7,798
Inventories (Note 4)	82,702	62,857
Prepaid expenses and other	5,800	4,662
Current assets of discontinued operations	1,261	2,094
Total current assets	238,001	221,800
Long-Term Assets		
Cash restricted	45,000	57,000
Property, plant and equipment	965,709	972,143
Investments	3	1
Unrealized foreign exchange rate derivative gain		5,933
Deferred note issuance and other costs	6,639	6,984
Deferred income tax	27,026	29,989
Note receivable, less current portion	8,408	8,744
	1,052,785	1,080,794
Total assets	1,290,786	1,302,594
LIABILITIES		
Current Liabilities		
Accounts payable and accrued expenses	88,918	84,173
Debt, current portion	33,364	33,903
Current liabilities of discontinued operations	1,074	1,926
Total current liabilities	123,356	120,002
Long-Term Liabilities		
Debt, less current portion (Note 8)	850,955	873,928
Unrealized interest rate derivative loss	35,670	41,355
Pension and other post-retirement benefit obligations	17,605	17,954
Capital leases	7,432	6,202
Deferred income tax	23,200	22,911
Other long-term liabilities	4,643	1,441

	939,505	963,791
Total liabilities	1,062,861	1,083,793
Minority Interest		
SHAREHOLDERS EQUITY		
Common shares (Note 8)	202,626	195,642
Additional paid-in capital	102	154
Retained earnings	15,526	15,240
Accumulated other comprehensive income	9,671	7,765
Total shareholders equity	227,925	218,801
Total liabilities and shareholders equity	1,290,786	1,302,594

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

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MERCER INTERNATIONAL INC.
CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS
For Three Months Ended March 31, 2007 and 2006
(Unaudited)
(Euros in thousands, except for loss per share)

	2007	2006
Revenues	169,531	141,668
Costs and expenses		
Operating costs	134,747	114,907
Operating depreciation and amortization	13,729	13,688
	21,055	13,073
General and administrative expenses	7,305	7,717
(Sale) purchase of emission allowances	(727)	(5,638)
Operating income from continuing operations	14,477	10,994
Other income (expense)		
Interest expense	(20,068)	(22,814)
Investment income	1,611	1,740
Unrealized foreign exchange gain on debt	1,254	6,113
Realized gain (loss) on derivative instruments (Note 5)	6,820	(3,562)
Unrealized (loss) gain on derivative instruments (Note 5)	(248)	44,377
Total other (expense) income	(10,631)	25,854
Income before income taxes and minority interest from continuing operations	3,846	36,848
Income tax provision	(3,801)	(21,113)
Income before minority interest from continuing operations	45	15,735
Minority interest	1,048	449
Net income from continuing operations	1,093	16,184
Net (loss) income from discontinued operations	(7)	404
Net income	1,086	16,588
Retained earnings (deficit), beginning of period (Restated Note 7)	14,440	(47,970)
Retained earnings (deficit), end of period	15,526	(31,382)
Net income per share from continuing operations (Note 3)		
Basic	0.03	0.49
Diluted	0.03	0.40

Income per share		
Basic	0.03	0.50
Diluted	0.03	0.41

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

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MERCER INTERNATIONAL INC.
CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME
For Three Months Ended March 31, 2007 and 2006
(Unaudited)
(Euros in thousands)

	2007	2006
Net income	1,086	16,588
Other comprehensive income (loss):		
Foreign currency translation adjustment	1,904	(2,985)
Pension plan additional minimum liability		(19)
Unrealized gains on securities		
Unrealized holding gains arising during the period	2	121
Other comprehensive income (loss)	1,906	(2,883)
Total comprehensive income	2,992	13,705

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

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MERCER INTERNATIONAL INC.
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
For Three Months Ended March 31, 2007 and 2006
(Unaudited)
(Euros in thousands)

	2007	2006
Cash Flows from (used in) Operating Activities:		
Net income	1,086	16,588
Adjustments to reconcile net loss to cash flows from operating activities		
Unrealized losses (gains) on derivatives	248	(40,815)
Unrealized foreign exchange gain on debt	(1,254)	(6,113)
Operating depreciation and amortization	13,729	14,162
Non-operating amortization	63	69
Minority interest	(1,048)	(449)
Deferred income taxes	3,252	20,782
Stock compensation expense	233	105
Other	578	(1,000)
Changes in current assets and liabilities		
Receivables	(21,732)	(4,603)
Inventories	(19,950)	8,968
Accounts payable and accrued expenses	6,171	(847)
Other	1,133	550
Net cash (used in) from operating activities	(17,491)	7,397
Cash Flows from (used in) Investing Activities:		
Cash restricted	12,000	(41,223)
Purchase of property, plant and equipment	(6,025)	(5,871)
Note receivable	268	
Net cash from (used in) investing activities	6,243	(47,094)
Cash Flows (used in) from Financing Activities:		
Decrease in construction costs payable	(907)	(153)
Proceeds from borrowings of notes payable and debt	5,210	42,163
Repayment of notes payable and debt	(17,431)	(4,802)
Repayment of capital lease obligations	(1,184)	(561)
Issuance of shares of common stock	246	
Net cash (used in) from financing activities	(14,066)	36,647
Effect of exchange rate changes on cash and cash equivalents	965	(147)
Net decrease in cash and cash equivalents	(24,349)	(3,197)
Cash and cash equivalents, beginning of period ⁽¹⁾	69,804	83,547
Cash and cash equivalents, end of period ⁽²⁾	45,455	80,350

Supplemental disclosure of cash flow information:

Cash paid during the period for:		
Interest	10,394	18,108
Income taxes		1,308
Supplemental schedule of non-cash investing and financing activities:		
Acquisition of production and other equipment under capital lease obligations	2,019	1,847
Common shares issued in satisfaction of floating rate note	6,728	

(1) Includes
 amounts related
 to discontinued
 operations of:
 2007
 437, 2006 772

(2) Includes
 amounts related
 to discontinued
 operations of:
 2007
 485, 2006
 1,275

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

**MERCER INTERNATIONAL INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
FOR THREE MONTHS ENDED MARCH 31, 2007**

(Unaudited)

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

Note 1. Basis of Presentation

Basis of Presentation

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

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

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MERCER INTERNATIONAL INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
FOR THREE MONTHS ENDED MARCH 31, 2007

(Unaudited)

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

Note 2. Stock-Based Compensation

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

Stock Options

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

Following is a summary of the status of options outstanding at March 31, 2007:

Exercise Price Range (In U.S. Dollars)	Outstanding Options			Exercisable Options	
	Number	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise price (In U.S. Dollars)	Number	Weighted Average Exercise Price (In U.S. Dollars)
\$5.65 - 6.375	830,000	3.25	\$6.29	830,000	\$6.29
8.50	135,000	0.25	8.50	135,000	8.50
7.30	30,000	8.25	7.30	20,000	7.30
7.92	83,334	8.50	7.92	50,000	7.92

During the three-month period ended March 31, 2007, 30,000 options were exercised at an exercise price of \$6.375 and 16,666 options were exercised at an exercise price of \$7.92 for cash proceeds of \$323,245. The average intrinsic value of the options exercised was \$5.12 per option. During the three-month period ended March 31, 2006 there were no options exercised.

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MERCER INTERNATIONAL INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
FOR THREE MONTHS ENDED MARCH 31, 2007

(Unaudited)

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

Note 2. Stock-Based Compensation (cont d)

Restricted Stock

The fair value of restricted stock is determined based upon the number of shares granted and the quoted price of the Company's stock on the date of grant. Restricted stock generally vests over two years. Expense is recognized on a straight-line basis over the vesting period. Expense recognized for the three months ended March 31, 2007 and 2006 was 72 and 98, respectively.

As at March 31, 2007, the total remaining unrecognized compensation cost related to restricted stock amounted to 171, which will be amortized over their remaining vesting period.

During the three month period ended March 31, 2007, there were restricted stock awards of an aggregate of Nil (2006 Nil) of our common shares to independent directors and officers of the Company and Nil (2006 Nil) restricted stock awards were cancelled.

As at March 31, 2007, the total number of restricted stock awards outstanding was 190,686.

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MERCER INTERNATIONAL INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
FOR THREE MONTHS ENDED MARCH 31, 2007

(Unaudited)

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

Note 3. Income Per Share

	Three Months Ended	
	March 31,	
	2007	2006
Net income from continuing operations basic	1,093	16,184
Interest on convertible notes, net of tax		1,452
Net income from continuing operations diluted	1,093	17,636
Net income from continuing operations per share:		
Basic	0.03	0.49
Diluted	0.03	0.40
Net income from continuing operations	1,093	16,184
Net (loss) income from discontinued operations	(7)	404
Net income Basic	1,086	16,588
Interest on convertible notes, net of tax		1,452
Net income Diluted	1,086	18,040
Net income per share:		
Basic	0.03	0.50
Diluted	0.03	0.41
Weighted average number of common shares outstanding:		
Basic	35,486,904	33,169,140
Effect of dilutive shares:		
Stock options and awards	492,578	255,095
Convertible notes		10,645,161
Diluted	35,979,482	44,069,396

The calculation of diluted income per share 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. Convertible notes excluded from the calculation of diluted income per share because they are anti-dilutive represented 9,428,022 and Nil for the three months ended March 31, 2007 and 2006, respectively.

MERCER INTERNATIONAL INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
FOR THREE MONTHS ENDED MARCH 31, 2007

(Unaudited)

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

Note 4. Inventories

	March 31, 2007	December 31, 2006
Raw materials	51,564	38,905
Finished goods	31,138	23,952
	82,702	62,857

Note 5. Derivatives Transactions

	Three Months Ended March 31,	
	2007	2006
Realized net gain (loss) on derivative financial instruments	6,820	(3,562)
Unrealized net gain on interest rate derivatives	5,685	23,506
Unrealized net (loss) gain on foreign exchange derivatives	(5,933)	20,871
Unrealized net (loss) gain on derivative financial instruments	(248)	44,377

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MERCER INTERNATIONAL INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
FOR THREE MONTHS ENDED MARCH 31, 2007

(Unaudited)

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

Note 6. Pension and Other Post-Retirement Benefit Obligations

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

The largest component of this obligation is with respect to the Celgar mill which maintains defined benefit pension plans and post-retirement benefits plans for certain employees. Pension benefits are based on employees' earnings and years of service. The pension plans are funded by contributions from the Company based on actuarial estimates and statutory requirements. Pension contributions for the three month periods ended March 31, 2007 and March 31, 2006 totaled 390 and 457, respectively.

	Three Months Ended March 31,			
	2007		2006	
	Pension Benefits	Post-Retirement Benefits	Pension Benefits	Post-Retirement Benefits
Service cost	201	113	226	115
Interest cost	327	178	356	192
Expected return on plan assets	(400)		(397)	
Recognized net loss		15		25
Net periodic benefit cost	128	306	185	332

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

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MERCER INTERNATIONAL INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
FOR THREE MONTHS ENDED MARCH 31, 2007

(Unaudited)

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

Note 7. Income Taxes

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

The Company adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, the Company established a 4,400 liability for unrecognized tax benefits, against which a 3,600 valuation allowance has already been booked. This net increase in the liability for unrecognized tax benefits of 800 has been accounted for as a reduction in the beginning balance of retained earnings on the Consolidated Condensed Balance Sheets included elsewhere in this quarterly report.

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

The Company recognizes interest and penalties related to unrecognized tax benefits in income tax expense. During the year ended December 31, 2006, the Company recognized approximately Nil in penalties and interest. The Company had Nil for the payment of interest and penalties accrued at December 31, 2006. Upon adoption of FIN 48 on January 1, 2007, the Company increased its accrual for interest and penalties to 800 from Nil.

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

Note 8. Floating Rate Note

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

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MERCER INTERNATIONAL INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
FOR THREE MONTHS ENDED MARCH 31, 2007

(Unaudited)

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

Note 9. Restricted Group Supplemental Disclosure

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

Combined Condensed Balance Sheet

	March 31, 2007			
	Restricted Group	Unrestricted Subsidiaries	Eliminations	Consolidated Group
ASSETS				
Current assets				
Cash and cash equivalents	32,540	12,430		44,970
Receivables	51,392	46,062		97,454
Note receivable, current portio				