

MERCER INTERNATIONAL INC.

Form 10-Q

August 04, 2011

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**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 June 30, 2011  
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)*

**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)*

**47-0956945**

*(I.R.S. Employer  
Identification No.)*

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months or for such shorter period that the registrant was required to submit and post such files). YES  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

Smaller Reporting  
Company

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 57,042,605 shares of common stock outstanding as at August 3, 2011.

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**MERCER INTERNATIONAL INC.**  
**INTERIM CONSOLIDATED FINANCIAL STATEMENTS**  
**FOR THE SIX MONTHS ENDED JUNE 30, 2011**  
**(Unaudited)**

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

	<b>June 30, 2011</b>	<b>December 31, 2010</b>
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	151,795	99,022
Receivables	104,235	121,709
Inventories (Note 4)	104,316	102,219
Prepaid expenses and other	10,689	11,360
Deferred income tax	24,928	22,570
 Total current assets	 395,963	 356,880
Long-term assets		
Property, plant and equipment	824,060	846,767
Deferred note issuance and other	9,933	11,082
Note receivable		1,346
	833,993	859,195
 Total assets	 1,229,956	 1,216,075
 <b>LIABILITIES</b>		
Current liabilities		
Accounts payable and accrued expenses	112,598	84,873
Pension and other post-retirement benefit obligations (Note 7)	692	728
Debt (Note 5)	44,152	39,596
 Total current liabilities	 157,442	 125,197
Long-term liabilities		
Debt (Note 5)	708,895	782,328
Unrealized interest rate derivative losses (Notes 6 and 9)	41,069	50,973
Pension and other post-retirement benefit obligations (Note 7)	23,048	24,236
Capital leases and other	11,242	12,010
Deferred income tax	14,404	7,768
	798,658	877,315
 Total liabilities	 956,100	 1,002,512
 <b>EQUITY</b>		
Shareholders' equity		

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Share capital (Note 8)	228,762	219,211
Paid-in capital	(5,609)	(3,899)
Retained earnings (deficit)	32,480	(10,956)
Accumulated other comprehensive income (loss)	34,715	31,712
Total shareholders' equity	290,348	236,068
Noncontrolling interest (deficit)	(16,492)	(22,505)
Total equity	273,856	213,563
Total liabilities and equity	1,229,956	1,216,075

Commitments and contingencies (Note 10)

Subsequent event (Note 11)

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

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

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Revenues				
Pulp	217,274	228,293	427,732	399,414
Energy	13,941	11,931	27,618	21,062
	231,215	240,224	455,350	420,476
Costs and expenses				
Operating costs	172,535	168,275	335,890	308,684
Operating depreciation and amortization	13,869	14,106	27,945	27,830
	44,811	57,843	91,515	83,962
Selling, general and administrative expenses	8,632	9,955	18,862	18,050
Purchase (sale) of emission allowances	(32)		(202)	
Operating income (loss)	36,211	47,888	72,855	65,912
Other income (expense)				
Interest expense	(14,883)	(16,898)	(30,789)	(33,321)
Investment income (loss)	136	117	463	211
Foreign exchange gain (loss) on debt	342	(9,371)	1,453	(14,602)
Gain (loss) on extinguishment of debt (Note 5)				(929)
Gain (loss) on derivative instruments (Note 6)	(2,339)	(4,462)	9,904	(11,008)
Total other income (expense)	(16,744)	(30,614)	(18,969)	(59,649)
Income (loss) before income taxes	19,467	17,274	53,886	6,263
Income tax benefit (provision) current	(1,478)	(1,319)	(2,297)	(1,523)
deferred	(2,140)		(2,140)	
Net income (loss)	15,849	15,955	49,449	4,740
Less: net loss (income) attributable to noncontrolling interest	(1,466)	(3,554)	(6,013)	115
Net income (loss) attributable to common shareholders	14,383	12,401	43,436	4,855
Net income (loss) per share attributable to common shareholders (Note 3)				
Basic	0.32	0.34	0.97	0.13

Diluted	0.26	0.23	0.77	0.11
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*The accompanying notes are an integral part of these interim consolidated financial statements.*

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

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Net income (loss) attributable to common shareholders	14,383	12,401	43,436	4,855
Retained earnings (deficit), beginning of period	18,097	(104,781)	(10,956)	(97,235)
Retained earnings (deficit), end of period	32,480	(92,380)	32,480	(92,380)

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

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Net income (loss)	15,849	15,955	49,449	4,740
Other comprehensive income (loss), net of taxes				
Foreign currency translation adjustment	(864)	(4,688)	2,600	2,944
Pension income (expense)	127	(234)	403	(600)
Unrealized gains (losses) on securities arising during the period	(6)	12		18
Other comprehensive income (loss), net of taxes	(743)	(4,910)	3,003	2,362
Total comprehensive income (loss)	15,106	11,045	52,452	7,102
Comprehensive loss (income) attributable to noncontrolling interest	(1,466)	(3,554)	(6,013)	115
Comprehensive income (loss) attributable to common shareholders	13,640	7,491	46,439	7,217

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



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

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Cash flows from (used in) operating activities				
Net income (loss) attributable to common shareholders	14,383	12,401	43,436	4,855
Adjustments to reconcile net income (loss) attributable to common shareholders to cash flows from operating activities				
Loss (gain) on derivative instruments	2,339	4,462	(9,904)	11,008
Foreign exchange loss (gain) on debt	(342)	9,371	(1,453)	14,602
Loss (gain) on extinguishment of debt				929
Depreciation and amortization	13,929	14,176	28,067	27,997
Accretion expense (income)	289	514	759	945
Noncontrolling interest	1,466	3,554	6,013	(115)
Deferred income taxes	2,140		2,140	
Stock compensation expense	471	227	2,539	733
Pension and other post-retirement expense, net of funding	7	138	(7)	332
Other	919	844	1,603	1,847
Changes in current assets and liabilities				
Receivables	5,523	(28,798)	12,700	(45,942)
Inventories	(8,399)	(5,724)	(4,086)	(10,983)
Accounts payable and accrued expenses	(833)	5,377	24,555	13,332
Other	485	687	844	(594)
Net cash from (used in) operating activities	32,377	17,229	107,206	18,946
Cash flows from (used in) investing activities				
Purchase of property, plant and equipment	(7,756)	(14,542)	(15,825)	(20,392)
Proceeds on sale of property, plant and equipment	27	162	380	549
Note receivable	375	579	771	495
Net cash from (used in) investing activities	(7,354)	(13,801)	(14,674)	(19,348)
Cash flows from (used in) financing activities				
Repayment of notes payable and debt			(30,351)	(8,250)
Repayment of capital lease obligations	(638)	(603)	(1,493)	(1,607)
Proceeds from borrowings of notes payable and debt		840		840
Proceeds from (repayment of) credit facilities, net		5,550	(14,652)	5,550
Proceeds from government grants	4,837	1,144	8,949	10,559

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Net cash from (used in) financing activities	4,199	6,931	(37,547)	7,092
Effect of exchange rate changes on cash and cash equivalents	(668)	3,094	(2,212)	4,164
Net increase (decrease) in cash and cash equivalents	28,554	13,453	52,773	10,854
Cash and cash equivalents, beginning of period	123,241	48,692	99,022	51,291
Cash and cash equivalents, end of period	151,795	62,145	151,795	62,145

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

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

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
<b>Supplemental disclosure of cash flow information</b>				
Cash paid (received) during the period for				
Interest	23,406	14,604	29,920	29,033
Income taxes	35	(37)	336	29
Supplemental schedule of non-cash investing and financing activities				
Acquisition of production and other equipment under capital lease obligations	(37)	318	273	530
Decrease (increase) in accounts payable relating to investing activities	6,321	(2,720)	6,376	(3,703)

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

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

**(In thousands of Euros, except per share data)**

**Note 1. The Company and Summary of Significant Accounting Policies**

*Basis of Presentation*

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

The interim consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (the SEC ). The year-end consolidated balance sheet data was derived from audited financial statements. The footnote disclosure included herein has been prepared in accordance with accounting principles generally accepted for interim financial statements in the United States ( GAAP ). The interim consolidated financial statements should be read together with the audited consolidated financial statements and accompanying notes included in the Company s latest annual report on Form 10-K for the fiscal year ended December 31, 2010. In the opinion of the Company, the unaudited interim consolidated financial statements contained herein contain all adjustments necessary to fairly present the results of the interim periods included. The results for the periods included herein may not be indicative of the results for the entire year.

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

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

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

*Use of Estimates*

Preparation of financial statements and related disclosures in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Significant management judgment is required in determining the accounting for, among other things, doubtful accounts and reserves, depreciation and amortization, future cash flows associated with impairment testing for long-lived assets, derivative financial instruments, environmental conservation and legal liabilities, asset retirement obligations, pensions and post-retirement benefit obligations, income taxes, contingencies, and inventory obsolescence and provisions. Actual results could differ from these estimates, and changes in these estimates are recorded when known.

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

**(In thousands of Euros, except per share data)**

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

*Recent Accounting Pronouncements*

In May 2011, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update 2011-04, *Fair Value Measurements* ( ASU 2011-04 ), which expands the existing disclosure requirements for fair value measurements (particularly for Level 3 inputs) defined under Accounting Standards Codification No. 820, *Fair Value Measurement* ( ASC 820 ), and makes other amendments. Many of the amendments to ASC 820 are being made to eliminate wording differences between GAAP and International Financial Reporting Standards and are not intended to result in a change in the application of the requirements of ASC 820. However, some of the amendments clarify the application of existing fair value measurement requirements and others change certain requirements for measuring fair value and could change how the fair value measurement guidance in ASC 820 is applied. The measurement and disclosure requirements of ASU 2011-04 are effective for reporting periods beginning after December 15, 2011 and are to be applied prospectively. The Company does not expect that the adoption of this new guidance will have a material impact on the consolidated financial statements or related note disclosures.

In June 2011, the FASB issued Accounting Standards Update 2011-05, *Presentation of Comprehensive Income* ( ASU 2011-05 ), which revises the manner in which entities present comprehensive income in their financial statements. The new guidance amends Accounting Standards Codification No. 220, *Comprehensive Income*, and gives reporting entities the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income in either a continuous statement of comprehensive income or two separate but consecutive statements. Under the two-statement approach, which the Company currently uses, the first statement includes components of net income, and the second statement includes components of other comprehensive income. ASU 2011-05 does not change the items that must be reported in other comprehensive income. This new guidance is effective for reporting periods beginning after December 15, 2011 and is to be applied retrospectively. The Company does not expect the adoption of this guidance to have an impact on the consolidated financial statements or related note disclosures.

**Note 2. Stock-Based Compensation**

In June 2010, the Company adopted a new stock incentive plan (the 2010 Plan ) which provides for options, restricted stock rights, restricted stock, performance shares, performance share units and stock appreciation rights to be awarded to employees, consultants and non-employee directors. As at June 30, 2011, after factoring in all allocated stock, there remain approximately 1.1 million common shares available for grant pursuant to the 2010 Plan.

*Performance Shares*

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

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

**(In thousands of Euros, except per share data)**

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

In February 2011, the Company awarded a total of 812,573 potential performance shares to employees of the Company, the majority of which vest using a partial vesting schedule between 2014 and 2016; 50% are scheduled to vest on January 1, 2014, 25% are scheduled to vest on January 1, 2015, and the remaining 25% are scheduled to vest on January 1, 2016. There were nil performance shares which had vested, been forfeited, or been cancelled during the three and six months ended June 30, 2011. Expense recognized for the three and six month periods ended June 30, 2011 was 245 and 759, respectively. Performance shares are expensed each reporting period based on their fair value, which is then amortized to reflect the time elapsed in the vesting period. The fair value of the performance shares is determined based upon the targeted number of shares awarded and the quoted price of the Company's stock at the reporting date. The target number of shares is determined using management's best estimate. The final determination of the number of shares to be granted will be made by the Board of Directors.

Between February and March 2011, the Company granted and issued a total of 474,728 shares of common stock for performance shares, which were originally awarded in 2008 and had vested on December 31, 2010. Pursuant to the accounting guidance in FASB's Accounting Standards Codification No. 718, *Compensation - Stock Compensation*, the Company adjusted the number of performance shares awarded to employees to the number granted by the Board of Directors, and accordingly adjusted compensation cost based on the fair value of Mercer's common stock at the grant date. As a result, the Company recognized approximately 1,420 associated with the final determination of these performance shares in the three months ended March 31, 2011. The fair value of these performance shares was determined based upon the number of shares granted and the quoted price of the Company's stock at the grant date.

*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 a one year period, except as noted below. Expense is recognized on a straight-line basis over the vesting period.

During the three months ended June 30, 2011, 38,000 restricted stock awards were granted to directors of the Company (2010 56,000). In the three months ended March 31, 2011, 200,000 (2010 nil) restricted stock awards were granted to the Chief Executive Officer of the Company, which vest in equal amounts over a five year period commencing in 2012.

There were no restricted stock awards cancelled or forfeited during the three and six month periods ended June 30, 2011. During the three months ended June 30, 2011, 56,000 restricted stock had vested. As at June 30, 2011, the total number of unvested restricted stock was 238,000 (2010 77,000).

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

**(In thousands of Euros, except per share data)**

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

Expense recognized for the three and six month periods ended June 30, 2011 was 265 and 396, respectively (2010 22 and 24). As at June 30, 2011, the total remaining unrecognized compensation cost related to restricted stock amounted to approximately 1,808 (2010 226), which will be amortized over the remaining vesting periods.

*Stock Options*

During the three and six month periods ended June 30, 2011 and 2010, no options were granted, exercised or cancelled, and nil and 15,000 options expired, respectively (2010 nil and 738,334). The aggregate intrinsic value of options outstanding and currently exercisable as at June 30, 2011 was \$3.56 per option.

Stock compensation expense recognized for stock options for the three and six month periods ended June 30, 2011 was nil (2010 nil). All stock options have fully vested.

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

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Net income (loss) attributable to common shareholders basic	14,383	12,401	43,436	4,855
Interest on convertible notes, net of tax	349	747	750	1,437
Net income (loss) attributable to common shareholders diluted	14,732	13,148	44,186	6,292
Net income (loss) per share attributable to common shareholders				
Basic	0.32	0.34	0.97	0.13
Diluted	0.26	0.23	0.77	0.11
Weighted average number of common shares outstanding:				
Basic <sup>(1)</sup>	45,521,094	36,349,340	44,805,877	36,334,846
Effect of dilutive instruments:				
Performance shares	107,468	425,668	472,860	429,865
Restricted stock	27,824	22,067	77,946	16,498
Stock options and awards	83,734		78,355	
Convertible notes	11,259,152	20,197,563	11,846,592	20,212,058
Diluted	56,999,272	56,994,638	57,281,630	56,993,267

(1) The basic weighted average number of shares excludes performance shares and restricted stock which have been issued, but have not vested as at June 30, 2011 and 2010.

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

The diluted net income (loss) per share calculation for the three and six month periods ended June 30, 2010 excluded 190,000 shares related to stock options, as the exercise price of these options was greater than their average market value, which would result in an anti-dilutive effect on diluted earnings per share.

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

**(In thousands of Euros, except per share data)**

**Note 4. Inventories**

	<b>June 30, 2011</b>	<b>December 31, 2010</b>
Raw materials	37,344	47,179
Finished goods	37,147	27,127
Work in process and other	29,825	27,913
	104,316	102,219

**Note 5. Debt**

Debt consists of the following:

	<b>June 30, 2011</b>	<b>December 31, 2010</b>
Note payable to bank, included in a total loan credit facility of 827,950 to finance the construction related to the Stendal mill (a)	486,074	500,657
Senior notes due February 2013, interest at 9.25% accrued and payable semi-annually, unsecured (b)		15,341
Senior notes due December 2017, interest at 9.50% accrued and payable semi-annually, unsecured (c)	206,569	224,031
Subordinated convertible notes due January 2012, interest at 8.5% accrued and payable semi-annually (d)	24,897	31,707
Credit agreement with a lender with respect to a revolving credit facility of C\$40 million (e)		15,016
Loan payable to the noncontrolling shareholder of the Stendal mill (f)	32,244	31,365
Credit agreement with a bank with respect to a revolving credit facility of 25,000 (g)		
Investment loan agreement with a lender with respect to the wash press project at the Rosenthal mill of 4,351 (h)	3,263	3,807
Credit agreement with a bank with respect to a revolving credit facility of 3,500 (i)		
	753,047	821,924
Less: current portion	(44,152)	(39,596)
Debt, less current portion	708,895	782,328

The Company made principal repayments under these facilities of 30,351 during the six months ended June 30, 2011 (2010 8,250). As of June 30, 2011, the principal maturities of debt are as follows:

<b>Matures</b>	<b>Amount</b>
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2011 <sup>(1)</sup>	34,023
2012	25,671
2013	41,088
2014	40,544
2015	44,000
Thereafter	567,721
	753,047

(1) Includes subordinated convertible notes due 2012 of 24,897 recorded as current debt as at June 30, 2011. See Note 11 Subsequent Event.

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

**(In thousands of Euros, except per share data)**

**Note 5. Debt (continued)**

Certain of the Company's debt instruments were issued under an indenture which, among other things, restricts Mercer Inc.'s ability and the ability of its restricted subsidiaries to make certain payments. These limitations are subject to other important qualifications and exceptions. As at June 30, 2011, the Company was in compliance with the terms of the indenture.

- (a) Note payable to bank, included in a total loan facility of 827,950 to finance the construction related to the Stendal mill ( Stendal Loan Facility ), interest at rates varying from Euribor plus 0.90% to Euribor plus 1.58% (rates on amounts of borrowing at June 30, 2011 range from 2.43% to 3.22%), principal due in required installments beginning September 30, 2006 until September 30, 2017, collateralized by the assets of the Stendal mill, with 48% and 32% guaranteed by the Federal Republic of Germany and the State of Saxony-Anhalt, respectively, of up to 433,573 of outstanding principal, subject to a debt service reserve account ( DSRA ) required to pay amounts due in the following twelve months under the terms of the Stendal Loan Facility; payment of dividends is only permitted if certain cash flow requirements are met. See Note 6 Derivative Transactions for a discussion of the Company's variable-to-fixed interest rate swaps.

On March 13, 2009, the Company finalized an agreement with its lenders to amend its Stendal Loan Facility. The amendment deferred approximately 164,000 of scheduled principal payments until the maturity date, September 30, 2017. The amendment also provided for a 100% cash sweep, referred to as the Cash Sweep , of any cash, in excess of a 15,000 working capital reserve and the guarantee amount, as discussed in Note 10, held by Stendal which will be used first to fund the DSRA to a level sufficient to service the amounts due and payable under the Stendal Loan Facility during the then following 12 months, which means the DSRA is Fully Funded , and second to prepay the deferred principal amounts. As at June 30, 2011, the DSRA balance was approximately 28,300.

- (b) In February 2005, the Company issued \$310 million of senior notes due February 2013 ( 2013 Notes ), which bore interest at 9.25%, accrued and payable semi-annually, and were unsecured.

On November 17, 2010, the Company used the proceeds from a private offering of \$300 million senior notes due 2017, described in Note 5(c) below and cash on hand to complete a tender offer to repurchase approximately \$289 million aggregate principal amount of its 2013 Notes. Pursuant to the FASB's Accounting Standards Codification No. 405, *Liabilities - Extinguishment of Liabilities* ( ASC 405-20 ), the Company concluded that the tendering of the 2013 Notes met the definition of a debt extinguishment. In connection with this tender offer and pursuant to FASB's Accounting Standards Codification No. 470-50, *Debt-Modifications and Extinguishments* ( ASC 470-50 ), the Company recorded approximately 7,500 to the loss on extinguishment of debt line in the Consolidated Statement of Operations which included the tender premium paid and the write-off of unamortized debt issue costs.

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**Note 5. Debt (continued)**

On February 15, 2011, the Company redeemed for cash all of its outstanding 2013 Notes, for a price equal to 100% of the principal amount of \$20.5 million, plus accrued and unpaid interest to, but not including February 15, 2011. In total, the Company paid approximately \$21.5 million ( 15,900) in connection with the redemption of the 2013 Notes.

- (c) On November 17, 2010, the Company completed a private offering of \$300 million in aggregate principal amount of Senior Notes due 2017 ( 2017 Notes ). The proceeds from this offering were used to finance the tender offer and consent solicitation for approximately \$289 million of the Company's 2013 Notes (see Note 5(b)). The 2017 Notes were issued at a price of 100% of their principal amount. The 2017 Notes will mature on December 1, 2017 and bear interest at 9.5% which is accrued and payable semi-annually.

The 2017 Notes are general unsecured senior obligations of the Company. The 2017 Notes rank equal in right of payment with all existing and future indebtedness of the Company and senior in right of payment to any current or future subordinated indebtedness of the Company. The 2017 Notes are effectively junior in right of payment to all borrowings of the Company's restricted subsidiaries, including borrowings under the Company's credit agreements which are secured by certain assets of its restricted subsidiaries.

The Company may redeem all or a part of the 2017 Notes, upon not less than 30 or more than 60 days' notice, at the redemption prices (expressed as percentages of principal amount) equal to 104.75% for the twelve month period beginning on December 1, 2014, 102.38% for the twelve month period beginning on December 1, 2015, and 100.00% beginning on December 1, 2016, and at any time thereafter, plus accrued and unpaid interest.

- (d) In December, 2009, the Company exchanged approximately \$43.3 million of Subordinated Convertible Notes due October 2010 (the 2010 Notes ) through two private exchange agreements with the holders thereof for approximately \$43.8 million of Subordinated Convertible Notes due January 2012 (the 2012 Notes ). On January 22, 2010, through an exchange offer with the remaining holders of the 2010 Notes, the Company exchanged a further \$21.7 million of 2010 Notes for approximately \$22.0 million of the Company's 2012 Notes. The Company recognized both exchange transactions of the Subordinated Convertible Notes as extinguishments of debt in accordance with ASC 470-50, because the fair value of the embedded conversion option changed by more than 10% in both transactions. During 2010, the Company recognized a loss of 929 as a result of the January 22, 2010 exchange. The loss was determined using the fair market value prevailing at the time of the transaction, and will be accreted to income through to January 2012 through interest expense yielding an effective interest rate of approximately 3% on the January 22, 2010 exchange.

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**Note 5. Debt (continued)**

The 2012 Notes bear interest at 8.50%, accrued and payable semi-annually, are convertible at any time by the holder into common shares of the Company at \$3.30 per share and are unsecured. The Company may redeem for cash all or a portion of the notes on or after July 15, 2011 at 100% of the principal amount of the notes plus accrued interest up to the redemption date. During the six months ended June 30, 2011, approximately \$7.4 million of Subordinated Convertible Notes due January 2012 were converted into 2,232,417 shares, respectively. Pursuant to the 2012 Notes indenture, on May 16, 2011, the Company issued notice that it will redeem all outstanding 2012 Notes on July 15, 2011, at 100% of the principal amount, plus accrued interest. See Note 11 Subsequent Event.

- (e) Credit agreement with respect to a revolving credit facility of C\$40.0 million for the Celgar mill. The credit agreement matures May 2013. Borrowings under the credit agreement are collateralized by the mill's inventory and receivables and are restricted by a borrowing base calculated on the mill's inventory and receivables. Canadian dollar denominated amounts bear interest at bankers acceptance plus 3.75% or Canadian prime plus 2.00%. U.S. dollar denominated amounts bear interest at LIBOR plus 3.75% or U.S. base plus 2.00%. The Company fully repaid this facility on March 30, 2011. As at June 30, 2011, approximately C\$2.1 million of this facility was supporting letters of credit, leaving approximately C\$28.2 million available.
- (f) A loan payable by the Stendal mill to its noncontrolling shareholder bears interest at 7.00%, and is accrued semi-annually. The loan payable is unsecured, subordinated to all liabilities of the Stendal mill, non-recourse to the Company and its restricted subsidiaries, and is due in 2017. The balance includes principal and accrued interest. During the first quarter of 2010, the noncontrolling shareholder converted 6,275 of accrued interest into a capital contribution.
- (g) A 25,000 working capital facility at the Rosenthal mill that matures in December 2012. Borrowings under the facility are collateralized by the mill's inventory and receivables and bear interest at Euribor plus 3.50%. As at June 30, 2011, approximately 2,200 of this facility was supporting bank guarantees leaving approximately 22,800 undrawn.
- (h) A four-year amortizing investment loan agreement with a lender relating to the new wash press at the Rosenthal mill with a total facility of 4,351 bearing interest at the rate of Euribor plus 2.75% that matures August 2013. Borrowings under this agreement are secured by the new wash press equipment. As at June 30, 2011, this facility was drawn by 3,263 and was accruing interest at a rate of 4.07%.

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**Note 5. Debt (continued)**

- (i) On February 8, 2010 the Rosenthal mill finalized a credit agreement with a lender for a 3,500 facility maturing in December 2012. Borrowings under this facility will bear interest at the rate of the 3-month Euribor plus 3.50% and are secured by certain land at the Rosenthal mill. As at June 30, 2011, this facility was undrawn.

**Note 6. Derivative Transactions**

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

During 2004, the Company entered into certain variable-to-fixed interest rate swaps in connection with the Stendal Loan Facility with respect to an aggregate maximum principal amount of approximately 612,600 of the total indebtedness under the Stendal Loan Facility. Under the interest rate swaps, the Company pays a fixed rate and receives a floating rate with the interest payments being calculated on a notional amount. Currently, the contracts have an aggregate notional amount of 426,518 at a fixed interest rate of 5.28% and they mature October 2017 (generally matching the maturity of the Stendal Loan Facility). The Company substantially converted the Stendal Loan Facility from a variable interest rate loan into a fixed interest rate loan, thereby reducing interest rate uncertainty.

The Company recognized an unrealized loss of 2,339 and gain of 9,904 on these interest rate swaps for the three and six months ended June 30, 2011, respectively (2010 a loss of 4,462 and 11,008), in the Gain (loss) on derivative instruments line in the Interim Consolidated Statements of Operations and Interim Consolidated Statements of Cash Flows. Derivative instruments are required to be measured at their fair value. Accordingly, the fair value of the interest rate swap is presented in Unrealized interest rate derivative losses within the long-term liabilities section in the Interim Consolidated Balance Sheets, which currently amounts to a cumulative unrealized loss of 41,069 (2010 50,973).

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

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**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 Rosenthal mills. The largest component of this obligation is with respect to the Celgar mill which maintains a defined benefit pension plan and post-retirement benefit plans for certain employees ( Celgar Plans ).

Pension benefits are based on employees' earnings and years of service. The Celgar Plans are funded by contributions from the Company based on actuarial estimates and statutory requirements. Pension contributions during the three and six month periods ended June 30, 2011 totaled 430 and 894, respectively (2010 247 and 399).

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

	<b>Three Months Ended June 30,</b>			
	<b>2011</b>		<b>2010</b>	
	<b>Pension Benefits</b>	<b>Post- Retirement Benefits</b>	<b>Pension Benefits</b>	<b>Post- Retirement Benefits</b>
Service cost	22	116	21	102
Interest cost	373	201	437	202
Expected return on plan assets	(383)		(409)	
Recognized net loss (gain)	126	(17)	115	(81)
Net periodic benefit cost	138	300	164	223

	<b>Six Months Ended June 30,</b>			
	<b>2011</b>		<b>2010</b>	
	<b>Pension Benefits</b>	<b>Post- Retirement Benefits</b>	<b>Pension Benefits</b>	<b>Post- Retirement Benefits</b>
Service cost	44	235	40	195
Interest cost	758	409	832	384
Expected return on plan assets	(777)		(778)	
Recognized net loss (gain)	256	(35)	218	(154)
Net periodic benefit cost	281	609	312	425

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**Note 8. Share Capital***Common shares*

The Company has authorized 200,000,000 common shares (2010 200,000,000) with a par value of \$1 per share. During the six months ended June 30, 2011, 2,232,417 shares were issued as a result of certain holders of the 2012 Notes exercising their conversion option (see Note 5(d) Debt). In addition, 358,268 shares were issued to employees of the Company as part of the stock based performance awards and 238,000 shares of restricted stock were issued to the Chief Executive Officer and directors of the Company.

As at June 30, 2011 and December 31, 2010, the Company had 45,828,343 and 42,999,658 common shares issued and outstanding, respectively.

*Preferred shares*

The Company has authorized 50,000,000 preferred shares (2010 50,000,000) with \$1 par value issuable in series, of which 2,000,000 shares have been designated as Series A. The preferred shares may be issued in one or more series and with such designations and preferences for each series as shall be stated in the resolutions providing for the designation and issue of each such series adopted by the Board of Directors of the Company. The Board of Directors is authorized by the Company's articles of incorporation to determine the voting, dividend, redemption and liquidation preferences pertaining to each such series. As at June 30, 2011, no preferred shares had been issued by the Company.

**Note 9. Financial Instruments**

The fair value of financial instruments at June 30, 2011 and December 31, 2010 is summarized as follows:

	<b>June 30, 2011</b>		<b>December 31, 2010</b>	
	<b>Carrying Amount</b>	<b>Fair Value</b>	<b>Carrying Amount</b>	<b>Fair Value</b>
Cash and cash equivalents	151,795	151,795	99,022	99,022
Investments	230	230	275	275
Receivables	104,235	104,235	121,709	121,709
Note receivable	1,997	1,997	2,978	2,978
Accounts payable and accrued expenses	112,598	112,598	84,873	84,873
Debt	753,047	798,321	821,924	847,875
Interest rate derivative contracts liability	41,069	41,069	50,973	50,973

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**Note 9. Financial Instruments (continued)**

The carrying value of cash and cash equivalents, notes receivable and accounts payable and accrued expenses approximates the fair value due to the immediate or short-term maturity of these financial instruments. The carrying value of receivables approximates the fair value due to their short-term nature and historical collectability. The fair value of debt reflects recent market transactions and discounted cash flow estimates. The fair value of the interest rate derivatives is calculated by discounting the future interest rate payments using a yield curve derived by recognized financial institutions. Investments are recorded at fair value based on recent transactions.

The fair value methodologies and, as a result, the fair value of the Company's investments and derivative instruments are determined based on the fair value hierarchy provided in FASB's Accounting Standards Codification No. 820, *Fair Value Measurements* (ASC 820). The fair value hierarchy per ASC 820 is as follows:

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

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

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

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

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

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

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**Note 9. Financial Instruments (continued)**

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

**Fair value measurements at June 30, 2011 using:**

Description	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	Total
<b>Assets</b>				
Investments (a)	230			230
<b>Liabilities</b>				
Derivatives (b)				
- Interest rate swaps		41,069		41,069

(a) Based on observable market data.

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

**Note 10. Commitments and Contingencies**

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

Pursuant to an arbitration proceeding with the general construction contractor of the Stendal mill regarding certain warranty claims, the Company acted upon a bank guarantee for defect liability on civil works that was about to expire as provided in the engineering, procurement, and construction contract. On January 28, 2011, the Company received approximately 10,000 (the Guarantee Amount), which is designed to compensate the Company for remediation work that is required at the Stendal mill, but it is less than the amount claimed by the Company under the arbitration. Consequently, the arbitration proceeding is ongoing, and there is no certainty that the Company will be successful with its claims. As at June 30, 2011, the Guarantee Amount was recognized as an increase in cash, and a corresponding increase in accounts payable.

**Note 11. Subsequent Event**

In May 2011, the Company issued a redemption notice effective July 15, 2011 for its 2012 Notes. Subsequently, in July 2011, substantially all of the outstanding 2012 Notes were converted into 11,214,262 common shares at a conversion price of \$3.30 per share, and the Company paid approximately \$1.5 million of accrued and unpaid interest. The remaining notes were redeemed by the Company on July 15, 2011 at par plus accrued and unpaid interest to, but not including, July 15, 2011.



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**Note 12. Restricted Group Supplemental Disclosure**

The terms of the indenture governing our 9.5% senior unsecured notes require that we provide the results of operations and financial condition of Mercer International Inc. and our restricted subsidiaries under the indenture, collectively referred to as the Restricted Group. As at and during the three and six months ended June 30, 2011 and 2010, the Restricted Group was comprised of Mercer International Inc., certain holding subsidiaries and our Rosenthal and Celgar mills. The Restricted Group excludes the Stendal mill.

**Combined Condensed Balance Sheets**

	<b>June 30, 2011</b>			
	<b>Restricted Group</b>	<b>Unrestricted Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated Group</b>
<b>ASSETS</b>				
Current assets				
Cash and cash equivalents	86,941	64,854		151,795
Receivables	51,854	52,381		104,235
Inventories	56,556	47,760		104,316
Prepaid expenses and other	6,745	3,944		10,689
Deferred income tax	24,928			24,928
Total current assets	227,024	168,939		395,963
Long-term assets				
Property, plant and equipment	348,193	475,867		824,060
Deferred note issuance and other	6,064	3,869		9,933
Due from unrestricted group	84,674		(84,674)	
Note receivable				
Total assets	665,955	648,675	(84,674)	1,229,956
<b>LIABILITIES</b>				
Current liabilities				
Accounts payable and accrued expenses	60,071	52,527		112,598
Pension and other post-retirement benefit obligations	692			692
Debt	25,985	18,167		44,152
Total current liabilities	86,748	70,694		157,442
Long-term liabilities				
Debt	208,744	500,151		708,895
Due to restricted group		84,674	(84,674)	
Unrealized interest rate derivative losses		41,069		41,069
Pension and other post-retirement benefit obligations	23,048			23,048

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Capital leases and other	6,766	4,476		11,242
Deferred income tax	14,404			14,404
Total liabilities	339,710	701,064	(84,674)	956,100
<b>EQUITY</b>				
Total shareholders' equity (deficit)	326,245	(35,897)		290,348
Noncontrolling interest (deficit)		(16,492)		(16,492)
Total liabilities and equity	665,955	648,675	(84,674)	1,229,956

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**Note 12. Restricted Group Supplemental Disclosure (continued)****Combined Condensed Balance Sheets**

	<b>December 31, 2010</b>			
	<b>Restricted Group</b>	<b>Unrestricted Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated Group</b>
<b>ASSETS</b>				
Current assets				
Cash and cash equivalents	50,654	48,368		99,022
Receivables	70,865	50,844		121,709
Inventories	60,910	41,309		102,219
Prepaid expenses and other	6,840	4,520		11,360
Deferred income tax	22,570			22,570
<b>Total current assets</b>	<b>211,839</b>	<b>145,041</b>		<b>356,880</b>
Long-term assets				
Property, plant and equipment	362,274	484,493		846,767
Deferred note issuance and other	6,903	4,179		11,082
Due from unrestricted group	80,582		(80,582)	
Note receivable	1,346			1,346
<b>Total assets</b>	<b>662,944</b>	<b>633,713</b>	<b>(80,582)</b>	<b>1,216,075</b>
<b>LIABILITIES</b>				
Current liabilities				
Accounts payable and accrued expenses	44,015	40,858		84,873
Pension and other post-retirement benefit obligations	728			728
Debt	16,429	23,167		39,596
<b>Total current liabilities</b>	<b>61,172</b>	<b>64,025</b>		<b>125,197</b>
Long-term liabilities				
Debt	273,473	508,855		782,328
Due to restricted group		80,582	(80,582)	
Unrealized interest rate derivative losses		50,973		50,973
Pension and other post-retirement benefit obligations	24,236			24,236
Capital leases and other	7,154	4,856		12,010
Deferred income tax	7,768			7,768
<b>Total liabilities</b>	<b>373,803</b>	<b>709,291</b>	<b>(80,582)</b>	<b>1,002,512</b>



**EQUITY**

Total shareholders' equity (deficit)	289,141	(53,073)		236,068
Noncontrolling interest (deficit)		(22,505)		(22,505)
Total liabilities and equity	662,944	633,713	(80,582)	1,216,075

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**Note 12. Restricted Group Supplemental Disclosure (continued)****Combined Condensed Statements of Operations**

	<b>Three Months Ended June 30, 2011</b>			<b>Consolidated Group</b>
	<b>Restricted Group</b>	<b>Unrestricted Subsidiaries</b>	<b>Eliminations</b>	
Revenues				
Pulp	125,238	92,036		217,274
Energy	5,701	8,240		13,941
	130,939	100,276		231,215
Operating costs	100,209	72,326		172,535
Operating depreciation and amortization	7,401	6,468		13,869
Selling, general and administrative expenses and other	5,301	3,299		8,600
	112,911	82,093		195,004
Operating income (loss)	18,028	18,183		36,211
Other income (expense)				
Interest expense	(6,433)	(9,684)	1,234	(14,883)
Investment income (loss)	1,305	65	(1,234)	136
Foreign exchange gain (loss) on debt	342			342
Gain (loss) on derivative instruments		(2,339)		(2,339)
Total other income (expense)	(4,786)	(11,958)		(16,744)
Income (loss) before income taxes	13,242	6,225		19,467
Income tax benefit (provision)	(2,851)	(767)		(3,618)
Net income (loss)	10,391	5,458		15,849
Less: net loss (income) attributable to noncontrolling interest		(1,466)		(1,466)
Net income (loss) attributable to common shareholders	10,391	3,992		14,383

	<b>Three Months Ended June 30, 2010</b>			<b>Consolidated Group</b>
	<b>Restricted Group</b>	<b>Unrestricted Subsidiaries</b>	<b>Eliminations</b>	

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

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**Note 12. Restricted Group Supplemental Disclosure (continued)**  
**Combined Condensed Statements of Operations**

	<b>Six Months Ended June 30, 2011</b>			<b>Consolidated Group</b>
	<b>Restricted Group</b>	<b>Unrestricted Subsidiaries</b>	<b>Eliminations</b>	
Revenues				
Pulp	240,464	187,268		427,732
Energy	11,547	16,071		27,618
	252,011	203,339		455,350
Operating costs	186,200	149,690		335,890
Operating depreciation and amortization	15,015	12,930		27,945
Selling, general and administrative expenses and other	11,492	7,168		18,660
	212,707	169,788		382,495
Operating income (loss)	39,304	33,551		72,855
Other income (expense)				
Interest expense	(13,706)	(19,535)	2,452	(30,789)
Investment income (loss)	2,584	331	(2,452)	463
Foreign exchange gain (loss) on debt	1,453			1,453
Gain (loss) on derivative instruments		9,904		9,904
Total other income (expense)	(9,669)	(9,300)		(18,969)
Income (loss) before income taxes	29,635	24,251		53,886
Income tax benefit (provision)	(3,375)	(1,062)		(4,437)
Net income (loss)	26,260	23,189		49,449
Less: net loss (income) attributable to noncontrolling interest		(6,013)		(6,013)
Net income (loss) attributable to common shareholders	26,260	17,176		43,436

	<b>Six Months Ended June 30, 2010</b>			<b>Consolidated Group</b>
	<b>Restricted Group</b>	<b>Unrestricted Subsidiaries</b>	<b>Eliminations</b>	

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

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**MERCER INTERNATIONAL INC.**  
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**(In thousands of Euros, except per share data)**

**Note 12. Restricted Group Supplemental Disclosure (continued)****Combined Condensed Statements of Cash Flows**

	<b>Three Months Ended June 30, 2011</b>		
	<b>Restricted Group</b>	<b>Unrestricted Group</b>	<b>Consolidated Group</b>
Cash flows from (used in) operating activities			
Net income (loss) attributable to common shareholders	10,391	3,992	14,383
Adjustments to reconcile net income (loss) attributable to common shareholders to cash flows from operating activities			
Loss (gain) on derivative instruments		2,339	2,339
Foreign exchange loss (gain) on debt	(342)		(342)
Depreciation and amortization	7,461	6,468	13,929
Accretion expense (income)	289		289
Noncontrolling interest		1,466	1,466
Deferred income taxes	2,140		2,140
Stock compensation expense	471		471
Pension and other post-retirement expense, net of funding	7		7
Other	232	687	919
Changes in current assets and liabilities			
Receivables	7,972	(2,449)	5,523
Inventories	2,616	(11,015)	(8,399)
Accounts payable and accrued expenses	2,721	(3,554)	(833)
Other <sup>(1)</sup>	(2,147)	2,632	485
Net cash from (used in) operating activities	31,811	566	32,377
Cash flows from (used in) investing activities			
Purchase of property, plant and equipment	(6,293)	(1,463)	(7,756)
Proceeds on sale of property, plant and equipment	16	11	27
Note receivable	375		375
Net cash from (used in) investing activities	(5,902)	(1,452)	(7,354)
Cash flows from (used in) financing activities			
Repayment of capital lease obligations	(339)	(299)	(638)
Proceeds from government grants	4,837		4,837
Net cash from (used in) financing activities	4,498	(299)	4,199
Effect of exchange rate changes on cash and cash equivalents	(668)		(668)
Net increase (decrease) in cash and cash equivalents	29,739	(1,185)	28,554

Cash and cash equivalents, beginning of period	57,202	66,039	123,241
Cash and cash equivalents, end of period	86,941	64,854	151,795

(1) Includes intercompany working capital related transactions.

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**(In thousands of Euros, except per share data)**

**Note 12. Restricted Group Supplemental Disclosure (continued)****Combined Condensed Statements of Cash Flows**

	<b>Three Months Ended June 30, 2010</b>		
	<b>Restricted Group</b>	<b>Unrestricted Group</b>	<b>Consolidated Group</b>
Cash flows from (used in) operating activities			
Net income (loss) attributable to common shareholders	2,075	10,326	12,401
Adjustments to reconcile net income (loss) attributable to common shareholders to cash flows from operating activities			
Loss (gain) on derivative instruments		4,462	4,462
Foreign exchange loss (gain) on debt	9,371		9,371
Depreciation and amortization	7,698	6,478	14,176
Accretion expense (income)	514		514
Noncontrolling interest		3,554	3,554
Stock compensation expense	227		227
Pension and other post-retirement expense, net of funding	138		138
Other	182	662	844
Changes in current assets and liabilities			
Receivables	(10,186)	(18,612)	(28,798)
Inventories	810	(6,534)	(5,724)
Accounts payable and accrued expenses	10,567	(5,190)	5,377
Other <sup>(1)</sup>	(4,860)	5,547	687
Net cash from (used in) operating activities	16,536	693	17,229
Cash flows from (used in) investing activities			
Purchase of property, plant and equipment	(14,148)	(394)	(14,542)
Proceeds on sale of property, plant and equipment	9	153	162
Note receivable	579		579
Net cash from (used in) investing activities	(13,560)	(241)	(13,801)
Cash flows from (used in) financing activities			
Repayment of capital lease obligations	(202)	(401)	(603)
Proceeds from borrowings of notes payable and debt	840		840
Proceeds from (repayment of) credit facilities, net	5,550		5,550
Proceeds from government grants	1,144		1,144
Net cash from (used in) financing activities	7,332	(401)	6,931
Effect of exchange rate changes on cash and cash equivalents	3,094		3,094



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

(1) Includes intercompany working capital related transactions.

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**MERCER INTERNATIONAL INC.**  
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**Note 12. Restricted Group Supplemental Disclosure (continued)****Combined Condensed Statements of Cash Flows**

	<b>Six Months Ended June 30, 2011</b>		
	<b>Restricted Group</b>	<b>Unrestricted Group</b>	<b>Consolidated Group</b>
Cash flows from (used in) operating activities			
Net income (loss) attributable to common shareholders	26,260	17,176	43,436
Adjustments to reconcile net income (loss) attributable to common shareholders to cash flows from operating activities			
Loss (gain) on derivative instruments		(9,904)	(9,904)
Foreign exchange loss (gain) on debt	(1,453)		(1,453)
Depreciation and amortization	15,137	12,930	28,067
Accretion expense (income)	759		759
Noncontrolling interest		6,013	6,013
Deferred income taxes	2,140		2,140
Stock compensation expense	2,539		2,539
Pension and other post-retirement expense, net of funding	(7)		(7)
Other	365	1,238	1,603
Changes in current assets and liabilities			
Receivables	14,231	(1,531)	12,700
Inventories	2,365	(6,451)	(4,086)
Accounts payable and accrued expenses	13,683	10,872	24,555
Other <sup>(1)</sup>	(3,869)	4,713	844
Net cash from (used in) operating activities	72,150	35,056	107,206
Cash flows from (used in) investing activities			
Purchase of property, plant and equipment	(12,001)	(3,824)	(15,825)
Proceeds on sale of property, plant and equipment	19	361	380
Note receivable	771		771
Net cash from (used in) investing activities	(11,211)	(3,463)	(14,674)
Cash flows from (used in) financing activities			
Repayment of notes payable and debt	(15,768)	(14,583)	(30,351)
Repayment of capital lease obligations	(861)	(632)	(1,493)
Proceeds from (repayment of) credit facilities, net	(14,652)		(14,652)
Proceeds from government grants	8,841	108	8,949
Net cash from (used in) financing activities	(22,440)	(15,107)	(37,547)
Effect of exchange rate changes on cash and cash equivalents	(2,212)		(2,212)

Net increase (decrease) in cash and cash equivalents	36,287	16,486	52,773
Cash and cash equivalents, beginning of period	50,654	48,368	99,022
Cash and cash equivalents, end of period	86,941	64,854	151,795

(1) Includes intercompany working capital related transactions.

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**MERCER INTERNATIONAL INC.**  
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**(Unaudited)**

**(In thousands of Euros, except per share data)**

**Note 12. Restricted Group Supplemental Disclosure (continued)****Combined Condensed Statement of Cash Flows**

	<b>Six Months Ended June 30, 2010</b>		
	<b>Restricted Group</b>	<b>Unrestricted Group</b>	<b>Consolidated Group</b>
Cash flows from (used in) operating activities			
Net income (loss) attributable to common shareholders	5,746	(891)	4,855
Adjustments to reconcile net income (loss) attributable to common shareholders to cash flows from operating activities			
Loss (gain) on derivative instruments		11,008	11,008
Foreign exchange loss (gain) on debt	14,602		14,602
Loss (gain) on extinguishment of convertible notes	929		929
Depreciation and amortization	15,008	12,989	27,997
Accretion expense (income)	945		945
Noncontrolling interest		(115)	(115)
Stock compensation expense	733		733
Pension and other post-retirement expense, net of funding	332		332
Other	570	1,277	1,847
Changes in current assets and liabilities			
Receivables	(26,568)	(19,374)	(45,942)
Inventories	617	(11,600)	(10,983)
Accounts payable and accrued expenses	7,722	5,610	13,332
Other <sup>(1)</sup>	(3,798)	3,204	(594)
Net cash from (used in) operating activities	16,838	2,108	18,946
Cash flows from (used in) investing activities			
Purchase of property, plant and equipment	(19,075)	(1,317)	(20,392)
Proceeds on sale of property, plant and equipment	63	486	549
Note receivable	495		495
Net cash from (used in) investing activities	(18,517)	(831)	(19,348)
Cash flows from (used in) financing activities			
Repayment of notes payable and debt		(8,250)	(8,250)
Repayment of capital lease obligations	(584)	(1,023)	(1,607)
Proceeds from borrowings of notes payable and debt	840		840
Proceeds from (repayment of) credit facilities, net	5,550		5,550
Proceeds from government grants	10,559		10,559
Net cash from (used in) financing activities	16,365	(9,273)	7,092
Effect of exchange rate changes on cash and cash equivalents	4,164		4,164

Net increase (decrease) in cash and cash equivalents	18,850	(7,996)	10,854
Cash and cash equivalents, beginning of period	20,635	30,656	51,291
Cash and cash equivalents, end of period	39,485	22,660	62,145

(1) Includes intercompany working capital related transactions.

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

In this document: (i) unless the context otherwise requires, references to we, our, us, the Company or Mercer International Inc. and its subsidiaries; (ii) references to Mercer Inc. mean the Company excluding its subsidiaries; (iii) information is provided as of June 30, 2011, unless otherwise stated; (iv) all references to monetary amounts are to Euros, the lawful currency adopted by most members of the European Union, unless otherwise stated; (v) refers to Euros, \$ refers to U.S. dollars and C\$ refers to Canadian dollars; (vi) ADMTs refers to air-dried tonnes; (vii) MW refers to megawatts and (viii) MWh refers to megawatt hours.

**Results of Operations**

***General***

We operate three northern bleached softwood kraft ( NBSK ) pulp mills through our wholly owned subsidiaries, Rosenthal and Celgar, and our 74.9% owned subsidiary, Stendal, which have a consolidated annual production capacity of approximately 1.5 million ADMTs.

The following discussion and analysis of our results of operations and financial condition for the three and six months ended June 30, 2011 should be read in conjunction with our interim 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, 2010 filed with the Securities and Exchange Commission (the SEC ).

***Current Market Environment***

During the second quarter of 2011, the global market for NBSK pulp remained well balanced, and prices remained at historically high levels. However, price increases in the quarter were largely offset by the weakening of the U.S. dollar. Subsequently, in July 2011, the seasonal summer slowdown resulted in softer demand and prices. Looking ahead into the balance of 2011, global NBSK pulp inventories are currently well balanced and we currently expect NBSK prices to remain generally strong in the near term.

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**Table of Contents****Second Quarter Operational Snapshot**

Selected production, sales and exchange rate data for the three and six months ended June 30, 2011 and 2010 is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Pulp Production ( 000 ADMTs)	367.9	359.7	726.5	689.1
Scheduled Production Downtime ( 000 ADMTs)	16.2	17.0	19.9	35.2
Pulp Sales ( 000 ADMTs)	357.6	365.0	706.6	697.9
Pulp Revenues (in millions)	217.3	228.3	427.7	399.4
Average NBSK pulp list prices in Europe (\$/ADMT)	\$ 1,017	\$ 957	\$ 988	\$ 908
Average NBSK pulp list prices in Europe ( /ADMT)	706	752	704	684
Average pulp sales realizations ( /ADMT)	599	618	596	565
Energy Production ( 000 MWh)	419.6	382.5	827.3	720.3
Energy Sales ( 000 MWh)	175.9	144.2	333.8	251.3
Energy Revenue (in millions)	13.9	11.9	27.6	21.1
Average energy sales realizations ( /MWh)	79	83	83	84
Average Spot Currency Exchange Rates				
/(\$)	0.6946	0.7865	0.7122	0.7547
C\$/\$( <sup>2</sup> )	0.9677	1.0277	0.9765	1.0345
C\$/( <sup>3</sup> )	1.3934	1.3073	1.3711	1.3739

(1) Average realized pulp prices for the periods indicated reflect customer discounts and pulp price movements between the order and shipment date.

(2) Average Federal Reserve Bank of New York noon spot rate over the reporting period.

(3) Average Bank of Canada noon spot rates over the reporting period.

**Three Months Ended June 30, 2011 Compared to Three Months Ended June 30, 2010**

Total revenues for the three months ended June 30, 2011 decreased slightly to 231.2 million (\$332.9 million) from 240.2 million (\$305.8 million) in the same period in 2010, primarily due to lower pulp revenues, partially offset by higher energy revenues.

Pulp revenues for the three months ended June 30, 2011 decreased to 217.3 million from 228.3 million in the comparative quarter of 2010, primarily due to a weaker U.S. dollar more than offsetting higher U.S. list pulp prices. The U.S. dollar was approximately 12% weaker versus the Euro in the current quarter compared to the same quarter of last year. Energy revenues increased by approximately 17% to a record 13.9 million in the second quarter from 11.9 million in the same quarter last year, primarily as a result of record energy sales at our German mills, combined with increased energy sales at our Celgar mill resulting from the Celgar Green Energy Project.

Pulp prices in the second quarter of 2011 were higher than in the same period last year due to the continued strengthening in global pulp markets. List prices for NBSK pulp in Europe were approximately \$1,017 ( 706) per ADMT in the current quarter compared to approximately \$957 ( 752) per ADMT in the second quarter of 2010 and \$950 ( 709) at the end of 2010. In the second quarter of 2011, average pulp sales realizations decreased to 599 per ADMT from 618 per ADMT in the same period last year, primarily due to a weaker U.S. dollar relative to the Euro.





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Pulp production increased to 367,914 ADMTs in the current quarter from 359,694 ADMTs in the same quarter of 2010, primarily due to record levels of production at our Rosenthal mill and only 11 days of scheduled maintenance downtime at our Celgar mill in the current quarter, compared to 12 days at the Celgar mill in the second quarter of 2010. We have 12 days (approximately 11,000 ADMTs) of scheduled maintenance downtime planned for our Rosenthal mill in the third quarter of 2011.

Pulp sales volume decreased to 357,585 ADMTs in the current quarter from 365,002 ADMTs in the comparative period of 2010, primarily as a result of an earlier seasonal market slowdown this year.

Costs and expenses in the second quarter of 2011 increased marginally to 195.0 million from 192.3 million in the comparative period of 2010, primarily due to slightly higher fiber costs at our German mills.

In the second quarter of 2011, operating depreciation and amortization decreased slightly to 13.9 million from 14.1 million in the same quarter last year. Selling, general and administrative expenses decreased to 8.6 million from 10.0 million in the second quarter of 2010, primarily as a result of a stronger Euro relative to the U.S. dollar.

Transportation costs marginally decreased to 16.7 million in the second quarter of 2011 from 17.0 million in the second quarter of 2010.

On average, our per unit fiber costs in the quarter increased by approximately 4% from the same period in 2010, primarily due to slightly higher fiber costs at our German mills as a result of strong demand for sawmill residuals and pulp logs in the early part of the second quarter of 2011. As we move into the second half of the year, we expect fiber prices for our German mills to be stable as the German fiber market is currently well balanced. We expect fiber prices at our Celgar mill to marginally increase in the short term due to a seasonal decrease in the availability of sawmill residuals.

For the second quarter of 2011, operating income decreased to 36.2 million from 47.9 million in the comparative quarter of 2010, primarily due to decreased pulp revenues resulting from a weaker U.S. dollar and lower sales volumes.

Interest expense in the second quarter of 2011 decreased to 14.9 million from 16.9 million in the comparative quarter of 2010, primarily due to reduced levels of debt associated with the Stendal mill and a weaker U.S. dollar versus the Euro.

Our Stendal mill recorded an unrealized loss of 2.3 million on the mark to market of its interest rate derivatives in the current quarter, compared to an unrealized loss of 4.5 million in the same quarter of last year. We recorded a foreign exchange gain of 0.3 million on our foreign currency denominated debt in the second quarter of 2011 compared to a foreign exchange loss of 9.4 million in the same period of 2010.

During the current quarter, we recorded 3.6 million of net income tax expense, compared to net income tax expense of 1.3 million in the same period last year.

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In the second quarter of 2011, the noncontrolling shareholder's interest in the Stendal mill's income was \$1.5 million, compared to income of \$3.6 million in the same quarter last year.

We reported net income attributable to common shareholders of \$14.4 million, or \$0.32 per basic and \$0.26 per diluted share for the second quarter of 2011, which included a non-cash unrealized loss of \$2.3 million on the Stendal interest rate derivatives and a \$0.3 million non-cash foreign exchange gain on our debt. In the second quarter of 2010, net income attributable to common shareholders was \$12.4 million, or \$0.34 per basic and \$0.23 per diluted share, which included a non-cash unrealized loss of \$4.5 million on the Stendal interest rate derivatives and a non-cash foreign exchange loss of \$9.4 million on our debt.

Operating EBITDA in the second quarter of 2011 was \$50.1 million, compared to \$62.1 million in the second quarter of 2010. Operating EBITDA is defined as operating income (loss) 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) attributable to common shareholders, including financing costs and the effect of derivative instruments. Operating EBITDA is not a measure of financial performance under the accounting principles generally accepted in the United States of America (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) noncontrolling interests on our Stendal mill operations; (v) the impact of realized or marked to market changes in our derivative positions, which can be substantial; and (vi) the impact of impairment charges against our investments or assets. Because of these limitations, Operating EBITDA should only be considered as a supplemental operational performance measure and should not be considered as a measure of liquidity or cash available to us to invest in the growth of our business. See the Statement of Cash Flows set out in our interim consolidated financial statements included herein. Because all companies do not calculate Operating EBITDA in the same manner, Operating EBITDA as calculated by us may differ from Operating EBITDA or EBITDA as calculated by other companies. We compensate for these limitations by using Operating EBITDA as a supplemental measure of our operational performance and relying primarily on our GAAP financial statements.

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The following table provides a reconciliation of net income (loss) attributable to common shareholders to operating income (loss) and Operating EBITDA for the periods indicated:

	<b>Three Months Ended June 30,</b>	
	<b>2011</b>	<b>2010</b>
	<b>(in thousands)</b>	
Net income attributable to common shareholders	14,383	12,401
Net income attributable to noncontrolling interest	1,466	3,554
Income taxes	3,618	1,319
Interest expense	14,883	16,898
Investment income	(136)	(117)
Foreign exchange (gain) loss on debt	(342)	9,371
Loss on derivative instruments	2,339	4,462
Operating income	36,211	47,888
Add: Depreciation and amortization	13,929	14,176
Operating EBITDA	50,140	62,064

***Six Months Ended June 30, 2011 Compared to Six Months Ended June 30, 2010***

Total revenues for the six months ended June 30, 2011 increased to 455.4 million (\$639.4 million) from 420.5 million (\$558.6 million) in the same period in 2010 due to both higher pulp and energy revenues.

Pulp revenues for the six months ended June 30, 2011 increased by approximately 7% to 427.7 million from 399.4 million in the comparative period of 2010, primarily due to both higher sales volumes and pulp prices, partially offset by a weaker U.S. dollar. The U.S. dollar was approximately 5% weaker versus the Euro in the first half of 2011, compared to the same period of 2010. Energy revenues increased by approximately 31% to a record 27.6 million in the first half of 2011 from 21.1 million in the comparative period last year, primarily as a result of energy sales from the Celgar Green Energy Project.

Pulp prices in the first half of 2011 were higher than in the same period last year due to the continued strengthening in global pulp markets. List prices for NBSK pulp in Europe were approximately \$988 ( 704) per ADMT in the first half of 2011, compared to approximately \$908 ( 684) per ADMT in the first half of 2010. In the first half of 2011, average pulp sales realizations increased by approximately 5% to 596 per ADMT from 565 per ADMT in the same period last year, primarily due to higher pulp prices being partially offset by a weaker U.S. dollar.

Pulp production increased to 726,471 ADMTs in the first half of 2011 from 689,149 ADMTs in the same period of 2010, primarily due to record levels of production at our Rosenthal and Stendal mills.

Pulp sales volume increased to 706,580 ADMTs in the first half of 2011 from 697,871 ADMTs in the comparative period of 2010, primarily as a result of continuing strong demand.

Costs and expenses in the first half of 2011 increased to 382.5 million from 354.6 million in the comparative period of 2010, primarily due to higher fiber costs.

In the first half of 2011, operating depreciation and amortization marginally increased to 27.9 million from 27.8 million in the same period last year. Selling, general and administrative expenses increased marginally to 18.9 million from 18.1 million in the first half of 2010.

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Transportation costs increased marginally to \$32.2 million in the first half of 2011 from \$31.3 million in the comparative period of 2010, primarily due to higher sales volumes.

On average, our per unit fiber costs in the first half of 2011 increased by approximately 11% from the same period in 2010, primarily due to higher fiber costs at our German mills as a result of strong demand for sawmill residuals and pulp logs in the second quarter of 2011. As we move into the second half of the year, we expect fiber prices for our German mills to be stable as the German fiber market is currently well balanced. We expect fiber prices at our Celgar mill to marginally increase in the short term due to a seasonal decrease in the availability of sawmill residuals.

For the first half of 2011, operating income increased by approximately 11% to \$72.9 million from \$65.9 million in the comparative period of 2010, primarily due to higher pulp prices.

Interest expense in the first half of 2011 decreased to \$30.8 million from \$33.3 million in the comparative period of 2010, primarily due to reduced levels of debt associated with the Stendal mill and a weaker U.S. dollar relative to the Euro.

Our Stendal mill recorded an unrealized gain of \$9.9 million on the mark to market of its interest rate derivatives in the first half of 2011, compared to an unrealized loss of \$11.0 million in the same period of last year. We recorded a foreign exchange gain of \$1.5 million on our foreign currency denominated debt in the first half of 2011 compared to a foreign exchange loss of \$14.6 million in the same period of 2010.

During the first half of 2011, we recorded \$4.4 million of net income tax expense, compared to net income tax expense of \$1.5 million in the same period of 2010.

In the first half of 2011, the noncontrolling shareholder's interest in the Stendal mill's income was \$6.0 million, compared to a loss of \$0.1 million in the same period last year.

We reported net income attributable to common shareholders of \$43.4 million, or \$0.97 per basic and \$0.77 per diluted share for the first six months of 2011, which included a non-cash unrealized gain of \$9.9 million on the Stendal interest rate derivatives and a \$1.5 million non-cash foreign exchange gain on our debt, partially offset by a non-cash charge for stock compensation of \$2.5 million. In the first six months of 2010, net income attributable to common shareholders was \$4.9 million, or \$0.13 per basic and \$0.11 per diluted share, which included non-cash unrealized losses of \$25.6 million on the Stendal interest rate derivatives and foreign exchange loss on our debt.

Operating EBITDA in the first half of 2011 was \$100.9 million, compared to \$93.9 million in the first half of 2010.

Operating EBITDA is defined as operating income (loss) plus depreciation and amortization and non-recurring capital asset impairment charges. 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 three months ended June 30, 2011 for additional information relating to such limitations and Operating EBITDA.

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The following table provides a reconciliation of net income (loss) attributable to common shareholders to operating income (loss) and Operating EBITDA for the periods indicated:

	<b>Six Months Ended</b>	
	<b>June 30,</b>	
	<b>2011</b>	<b>2010</b>
	<b>(in thousands)</b>	
Net income attributable to common shareholders	43,436	4,855
Net income (loss) attributable to noncontrolling interest	6,013	(115)
Income taxes	4,437	1,523
Interest expense	30,789	33,321
Investment income	(463)	(211)
Foreign exchange (gain) loss on debt	(1,453)	14,602
Loss on extinguishment of debt		929
Loss (gain) on derivative instruments	(9,904)	11,008
Operating income	72,855	65,912
Add: Depreciation and amortization	28,067	27,997
Operating EBITDA	100,922	93,909

**Liquidity and Capital Resources**

The following table is a summary of selected financial information at the dates indicated:

	<b>As at</b>	<b>As at</b>
	<b>June 30,</b>	<b>December 31,</b>
	<b>2011</b>	<b>2010</b>
	<b>(in thousands)</b>	
<b>Financial Position</b>		
Cash and cash equivalents	151,795	99,022
Working capital	238,521	231,683
Property, plant and equipment	824,060	846,767
Total assets	1,229,956	1,216,075
Long-term liabilities	798,658 <sup>(1)</sup>	877,315
Total equity	273,856 <sup>(1)</sup>	213,563

(1) 24.9 million of 8.5% convertible notes were converted into shares in July 2011.

As at June 30, 2011, our cash and cash equivalents had increased to 151.8 million from 99.0 million at the end of 2010, and working capital had increased to 238.5 million from 231.7 million at the end of 2010.

**Sources and Uses of Funds**

Our principal sources of funds are cash flows from operations, cash on hand and the revolving working capital loan facilities for our Celgar and Rosenthal mills. Our principal uses of funds consist of operating expenditures, payments of principal and interest on the project loan facility relating to our Stendal mill ( Stendal Loan Facility ), capital expenditures and interest payments on our outstanding 9.5% senior notes due 2017 (the Senior Notes ) and our 8.5% convertible senior subordinated notes due 2012 (the Convertible Notes ).

During the second quarter of 2011, we announced the redemption of all of our \$37.0 million of Convertible Notes. Substantially all of the Convertible Notes were subsequently converted into approximately 11.2 million shares and, as of July 15, 2011, no Convertible Notes remain outstanding.



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At June 30, 2011, our Celgar mill had approximately C\$4.7 million of grant monies related to holdbacks that we expect to receive in the second half of 2011 from the Government of Canada in regard to the completion of the Celgar Energy Project. Additionally, in March 2011, the Company finalized a contribution agreement with Natural Resources Canada, or NRCan, for approximately C\$9.7 million of unallocated Green Transformation Program or GTP funds to be used towards improving the fiber line and oxygen delignification process at the Celgar mill. As of June 30, 2011, the Company had received approximately C\$6.6 million of such funds.

During the first quarter of 2011, the Company finalized a contribution agreement under the Government of Canada's Transformative Technology Program to fund approximately 50% of the capital cost associated with the installation of our generator acid purification system at our Celgar mill. In July 2011, we received approximately C\$1.6 million (1.1 million) from the Canadian government related to this project.

***Debt Covenants***

Our long-term obligations contain various financial tests and covenants customary to these types of arrangements. As at June 30, 2011, we were in compliance with all of the covenants of our indebtedness.

***Cash Flow Analysis***

***Cash Flows from Operating Activities.*** We operate in a cyclical industry and our operating cash flows vary accordingly. Our principal operating cash expenditures are for labor, fiber, chemicals and debt service.

Working capital levels fluctuate throughout the year and are affected by maintenance downtime, changing sales patterns, seasonality and the timing of receivables and the payment of payables and expenses.

Cash provided by operating activities increased to 107.2 million in the six months ended June 30, 2011 from 18.9 million in the same period of 2010, primarily due to significantly higher net income and a decrease in receivables. A decrease in receivables provided cash of 12.7 million in the first six months of 2011, compared to an increase in receivables using cash of 45.9 million in the first six months of 2010. An increase in inventories used cash of 4.1 million in the first six months of 2011, compared to an increase in inventories using cash of 11.0 million in the first six months of 2010. An increase in accounts payable and accrued expenses provided cash of 24.6 million in the first six months of 2011, compared to an increase in accounts payable and accrued expenses providing cash of 13.3 million, in the first six months of 2010.

***Cash Flows from Investing Activities.*** Investing activities in the first six months of 2011 used cash of 14.7 million, compared to using cash of 19.3 million in the same period of 2010. Capital expenditures in the first six months of 2011 used cash of 15.8 million, compared to 20.4 million in the same period of 2010. Capital expenditures in the first half of 2011 primarily related to improving the fiber line and oxygen delignification process at the Celgar mill.

***Cash Flows from Financing Activities.*** In the first six months of 2011, financing activities used cash of 37.5 million, compared to providing cash of 7.1 million in the same period last year. In the first half of 2011, we used cash of 30.4 million to redeem our 9.25% senior notes due 2013 and used cash of 14.7 million to repay the balance of our Celgar revolving credit facility. In the same period of 2010, net repayment of debt and credit facilities used cash of 1.9 million. We received cash of 8.9 million from government grants in the first half of 2011, while receiving cash of 10.6 million from government grants in the comparative period of 2010.

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***Capital Resources***

We have no material commitments to acquire assets or operating businesses.

***Future Liquidity***

Based upon the current level of operations and our current expectations for future periods in light of the current economic environment, and in particular, current and expected pulp pricing and foreign exchange rates, we believe that cash flow from operations and available cash, together with available borrowings will be adequate to meet our liquidity needs in the next 12 months.

***Contractual Obligations and Commitments***

There were no material changes outside the ordinary course to any of our material contractual obligations during the first six months of 2011.

***Foreign Currency***

Our reporting currency is the Euro as the majority of our business transactions are denominated in Euros. However, we hold certain assets and liabilities in U.S. dollars and Canadian dollars. Accordingly, our consolidated financial results are subject to foreign currency exchange rate fluctuations.

We translate foreign denominated assets and liabilities into Euros at the rate of exchange on the balance sheet date. Equity accounts are translated using historical exchange rates. Unrealized gains or losses from these translations are recorded in our consolidated statement of comprehensive income and impact shareholders' equity on the balance sheet but do not affect our net income.

In the six months ended June 30, 2011, accumulated other comprehensive income increased by 3.0 million to 34.7 million, primarily due to the foreign currency translation adjustment.

Based upon the exchange rate at June 30, 2011, the U.S. dollar has weakened by approximately 15% in value against the Euro since June 30, 2010. See *Quantitative and Qualitative Disclosures about Market Risk*.

***Results of Operations of the Restricted Group under our Senior Note Indenture***

The indenture governing our Senior Notes requires that we also provide a discussion in annual and quarterly reports we file with the SEC under Management's Discussion and Analysis of Financial Condition and Results of Operations of the results of operations and financial condition of Mercer Inc. and our restricted subsidiaries under the indenture, referred to as the *Restricted Group*. The *Restricted Group* is comprised of Mercer Inc., our Rosenthal and Celgar mills and certain holding subsidiaries. The *Restricted Group* excludes our Stendal mill.

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The following is a discussion of the results of operations and financial condition of the Restricted Group. For further information regarding the Restricted Group including, without limitation, a reconciliation to our consolidated results of operations, see Note 12 of our Interim Consolidated Financial Statements included herein.

***Restricted Group Results Three Months Ended June 30, 2011 Compared to Three Months Ended June 30, 2010***

Total revenues for the Restricted Group increased to 130.9 million (\$188.5 million) in the second quarter of 2011, compared to 128.7 million (\$163.8 million) in the second quarter of 2010 due to higher energy revenues.

Pulp revenues for the Restricted Group for the three months ended June 30, 2011 increased slightly to 125.2 million from 124.8 million in the comparative period of 2010, primarily due to higher pulp prices and sales volumes, partially offset by a weaker U.S. dollar. The U.S. dollar was approximately 12% weaker versus the Euro in the second quarter of 2011 compared to the second quarter of 2010. Energy revenues increased by approximately 50% in the current quarter to a record 5.7 million from 3.8 million in the same period last year, primarily due to energy sales from the Celgar energy project in 2011.

In the second quarter of 2011, pulp prices were higher than in the same quarter of 2010 due to continued strengthening in global pulp markets. List prices for NBSK pulp in Europe were approximately \$1,017 ( 706) per ADMT in the current quarter compared to approximately \$957 ( 752) per ADMT in the second quarter of 2010. In the second quarter of 2011, average pulp sales realizations for the Restricted Group decreased to 604 per ADMT from 621 per ADMT in the same period last year due to a weaker U.S. dollar more than offsetting higher U.S. list pulp prices.

Pulp production for the Restricted Group increased to 199,926 ADMTs in the second quarter of 2011 from 193,697 ADMTs in the same period of 2010, primarily as a result of record levels of production at our Rosenthal mill.

Pulp sales volume of the Restricted Group increased to 207,199 ADMTs in the second quarter of 2011 from 200,680 ADMTs in the comparative period of 2010, primarily due to strong demand.

Costs and expenses for the Restricted Group in the second quarter of 2011 increased to 112.9 million from 110.2 million in the comparative period of 2010, primarily due to higher fiber costs at our Rosenthal mill.

In the second quarter of 2011, operating depreciation and amortization for the Restricted Group decreased to 7.4 million from 7.6 million in the same period last year. Selling, general and administrative expenses and other for the Restricted Group decreased to 5.3 million from 6.7 million in the comparative period of 2010, primarily as a result of a weaker U.S. dollar relative to the Euro and the Canadian dollar.

Transportation costs for the Restricted Group marginally decreased to 12.3 million in the second quarter of 2011 from 12.6 million in the same quarter last year.

Overall, per unit fiber costs of the Restricted Group in the second quarter of 2011 marginally increased by approximately 1% compared to the same period in 2010.

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In the second quarter of 2011, the Restricted Group reported operating income of 18.0 million compared to operating income of 18.5 million in the second quarter of 2010, primarily due to lower price realizations resulting from a weaker U.S. dollar.

Interest expense for the Restricted Group decreased to 6.4 million in the second quarter of 2011 from 8.0 million in the same quarter last year, primarily due to a weaker U.S. dollar relative to the Euro and lower debt levels.

In the second quarter of 2011, the Restricted Group recorded a foreign exchange gain on foreign currency denominated debt of 0.3 million, compared to a loss on foreign currency denominated debt of 9.4 million in the comparative quarter of 2010.

During the second quarter of 2011, the Restricted Group recorded 2.9 million of net income tax expense, compared to net income tax expense of 0.3 million in the same period last year.

The Restricted Group reported net income for the second quarter of 2011 of 10.4 million compared to net income of 2.1 million in the same period last year.

In the second quarter of 2011, the Restricted Group reported Operating EBITDA of 25.5 million compared to Operating EBITDA of 26.2 million in the comparative quarter of 2010. Operating EBITDA is defined as operating income (loss) plus depreciation and amortization and non-recurring capital asset impairment charges. 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 three months ended June 30, 2011 for additional information relating to such limitations and Operating EBITDA.

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

	<b>Three Months Ended</b>	
	<b>June 30,</b>	
	<b>2011</b>	<b>2010</b>
	<b>(in thousands)</b>	
<b>Restricted Group<sup>(1)</sup></b>		
Net income	10,391	2,075
Income taxes	2,851	334
Interest expense	6,433	7,957
Investment income	(1,305)	(1,285)
Foreign exchange (gain) loss on debt	(342)	9,371
Operating income	18,028	18,452
Add: Depreciation and amortization	7,461	7,698
Operating EBITDA	25,489	26,150

(1) See Note 12 of the interim consolidated financial statements included elsewhere herein for a reconciliation to our consolidated results.

**Restricted Group Results Six Months Ended June 30, 2011 Compared to Six Months Ended June 30, 2010**

Total revenues for the Restricted Group increased to 252.0 million (\$353.8 million) in the first half of 2011, compared to 238.5 million (\$316.8 million) in the first half of 2010 due to both higher pulp and energy revenues.

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Pulp revenues for the Restricted Group for the six months ended June 30, 2011 increased by approximately 4% to 240.5 million from 231.3 million in the comparative period of 2010, primarily due to higher pulp prices, partially offset by a weaker U.S. dollar. Energy revenues increased by approximately 60% in the first half of 2011 to a record 11.5 million from 7.2 million in the same period last year, primarily due to energy sales from the Celgar energy project.

In the first half of 2011, pulp prices were higher than in the same period of 2010 due to continued strengthening in global pulp markets. List prices for NBSK pulp in Europe were approximately \$988 ( 704) per ADMT in the first half of 2011, compared to approximately \$908 ( 684) per ADMT in the first half of 2010. In the first half of 2011, average pulp sales realizations for the Restricted Group increased by approximately 6% to 600 per ADMT from 566 per ADMT in the same period last year.

Pulp production for the Restricted Group increased marginally to 404,232 ADMTs in the first half of 2011 from 404,033 ADMTs in the same period of 2010, primarily as a result of record production levels at our Rosenthal mill being partially offset by minor temporary equipment failures adversely affecting production at our Celgar mill in the first quarter of 2011.

Pulp sales volume of the Restricted Group decreased slightly to 400,435 ADMTs in the first half of 2011 from 408,111 ADMTs in the comparative period of 2010, primarily due to lower production levels at our Celgar mill in the first quarter of 2011.

Costs and expenses for the Restricted Group in the first half of 2011 increased to 212.7 million from 203.9 million in the comparative period of 2010, primarily due to higher fiber costs at our Rosenthal mill.

In the first half of 2011, operating depreciation and amortization for the Restricted Group marginally increased to 15.0 million from 14.8 million in the same period last year. Selling, general and administrative expenses and other for the Restricted Group marginally decreased to 11.5 million from 11.6 million in the comparative period of 2010.

Transportation costs for the Restricted Group marginally decreased to 23.6 million in the first half of 2011 from 23.8 million in the comparative period of 2010.

Overall, per unit fiber costs of the Restricted Group in the first half of 2011 increased by approximately 8% compared to the same period in 2010, primarily due to higher fiber costs at our Rosenthal mill resulting from strong demand for German sawmill residuals and pulp logs.

In the first half of 2011, the Restricted Group reported operating income of 39.3 million compared to operating income of 34.5 million in the comparative period of 2010, primarily due to significantly higher pulp prices being partially offset by a weaker U.S. dollar.

Interest expense for the Restricted Group decreased to approximately 13.7 million in the first half of 2011 from 15.3 million in the first half of 2010, primarily as a result of lower debt levels and a weaker U.S. dollar relative to the Euro.

In the first six months of 2011, the Restricted Group recorded a foreign exchange gain on foreign currency denominated debt of 1.5 million, compared to a loss on foreign currency denominated debt of 14.6 million in the comparative period of 2010.

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During the first half of 2011, the Restricted Group recorded 3.4 million of net income tax expense, compared to net income tax expense of 0.5 million in the same period last year.

The Restricted Group reported net income for the first six months of 2011 of 26.3 million compared to net income of 5.7 million in the same period last year.

In the first half of 2011, the Restricted Group reported Operating EBITDA of 54.4 million compared to Operating EBITDA of 49.5 million in the comparative period of 2010. Operating EBITDA is defined as operating income (loss) plus depreciation and amortization and non-recurring capital asset impairment charges. 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 three months ended June 30, 2011 for additional information relating to such limitations and Operating EBITDA.

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

	<b>Six Months Ended June 30,</b>	
	<b>2011</b>	<b>2010</b>
	<b>(in thousands)</b>	
<b>Restricted Group<sup>(1)</sup></b>		
Net income	26,260	5,746
Income taxes	3,375	495
Interest expense	13,706	15,277
Investment income	(2,584)	(2,524)
Foreign exchange (gain) loss on debt	(1,453)	14,602
Loss on extinguishment of debt		929
Operating income	39,304	34,525
Add: Depreciation and amortization	15,137	15,008
Operating EBITDA	54,441	49,533

(1) See Note 12 of the interim consolidated financial statements included elsewhere herein for a reconciliation to our consolidated results.

**Liquidity and Capital Resources of the Restricted Group**

The following table is a summary of selected financial information for the Restricted Group at the dates indicated:

	<b>As at June 30, 2011</b>	<b>As at December 31, 2010</b>
	<b>(in thousands)</b>	
<b>Restricted Group Financial Position<sup>(1)</sup></b>		
Cash and cash equivalents	86,941	50,654
Working capital	140,276	150,667
Property, plant and equipment	348,193	362,274
Total assets	665,955	662,944
Long-term liabilities	252,962 <sup>(2)</sup>	312,631
Total equity	326,245 <sup>(2)</sup>	289,141

(1) See Note 12 of the interim consolidated financial statements included elsewhere herein for a reconciliation to our consolidated results.

(2) 24.9 million of Convertible Notes were converted into shares in July 2011.

At June 30, 2011, cash and cash equivalents for the Restricted Group increased to 86.9 million from 50.7 million at the end of 2010.

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We currently expect the Restricted Group to meet its interest and debt service obligations and meet the working and maintenance capital requirements for its operations for the next 12 months with cash flow from operations, cash on hand and available borrowings.

**Credit Ratings**

Standard & Poor's Rating Services ( S&P ) and Moody's Investors Service, Inc. base their assessment of our credit risk on the business and financial profile of the Restricted Group only. Factors that may affect our credit rating include changes in our operating performance and liquidity. Credit rating downgrades can adversely impact, among other things, future borrowing costs and access to capital markets.

In July 2011, S&P raised its ratings on the Senior Notes from B to B+ and improved its recovery rating from 4 to 3 . The improved ratings reflect Mercer's balance sheet deleveraging in the first half of 2011 and S&P's belief that demand for NBSK pulp will remain robust and that the Company's liquidity position should continue to improve throughout the remainder of 2011.

**Critical Accounting Policies**

The preparation of financial statements and related disclosures in conformity with GAAP requires management to make estimates and assumptions that affect both the amount and the timing of the recording of assets, liabilities, revenues, and expenses in the consolidated financial statements and accompanying note disclosure. 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.

Our significant accounting policies are disclosed in Note 1 to our annual report on Form 10-K for the fiscal year ended December 31, 2010. While all of the significant accounting policies are important to the consolidated financial statements, some of these policies may be viewed as having a high degree of judgment. On an ongoing basis, using currently available information, management reviews its estimates, including those related to the accounting for pensions and post-retirement benefits, provisions for bad debt and doubtful accounts, derivative instruments, impairment of long-lived assets, deferred taxes, inventory provisions and environmental conservation and legal liabilities. Actual results could differ from these estimates.

We have identified certain accounting policies that are the most important to the portrayal of our current financial condition and results of operations.

For information about both our significant and critical accounting policies, see our annual report on Form 10-K for the fiscal year ended December 31, 2010.

**New Accounting Standards**

See Note 1 to the Company's interim consolidated financial statements included in Item 1.

**Cautionary Statement Regarding Forward-Looking Information**

The statements in this report that are not reported financial results or other historical information are forward-looking statements within the meaning of the *Private Securities Litigation Reform Act of 1995*, as amended.

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Generally, forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. They often include words such as expects, anticipates, intends, plans, believes, seeks, or words of similar meaning, or future or conditional verbs, such as will, should, could, or may, although not all forward-looking statements contain these identifying words. Forward-looking statements are based on expectations, forecasts and assumptions by our management and involve a number of risks, uncertainties and other factors, many of which are beyond our control, that could cause actual conditions, events or results to differ significantly from those described in the forward-looking statements. These factors include, but are not limited to, the following:

- the highly cyclical nature of our business;
- our level of indebtedness could negatively impact our financial condition and results of operations;
- a weak global economy could adversely affect our business and financial results and have a material adverse effect on our liquidity and capital resources;
- in a weak pulp price and demand environment there can be no assurance that we will be able to generate sufficient cash flows, to service, repay or refinance debt;
- cyclical fluctuations in the price and supply of our raw materials could adversely affect our business;
- we operate in highly competitive markets;
- we are exposed to currency exchange rate and interest rate fluctuations;
- increases in our capital expenditures or maintenance costs could have a material adverse effect on our cash flow and our ability to satisfy our debt obligations;
- we use derivatives to manage certain risks which has caused significant fluctuations in our operating results;
- we are subject to extensive environmental regulation and we could have environmental liabilities at our facilities;
- our business is subject to risks associated with climate change and social government responses thereto;
- we are subject to risks related to our employees;
- we rely on German federal and state government grants and guarantees;
- risks relating to our participation in the European Union Emissions Trading Scheme and the application of Germany's *Renewable Energy Resources Act*;
- we are dependent on key personnel;
- we may experience material disruptions to our production;
- we may incur losses as a result of unforeseen or catastrophic events, including the emergence of a pandemic, terrorist attacks or natural disasters;
- our insurance coverage may not be adequate; and
- we rely on third parties for transportation services.

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Given these uncertainties, you should not place undue reliance on our forward-looking statements. The forgoing review of important factors is not exhaustive or necessarily in order of importance and should be read in conjunction with the risks and assumptions including 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 fiscal year ended December 31, 2010. 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.

**Cyclical Nature of Business**

*Revenues*

The pulp business is highly cyclical in nature and markets for our principal products are characterized by periods of supply and demand imbalance, which in turn affects product prices. Pulp markets are highly competitive and are sensitive to cyclical changes in the global economy, industry capacity and foreign exchange rates, all of which can have a significant influence on selling prices and our operating results. The length and magnitude of industry cycles have varied over time but generally reflect changes in macro-economic conditions and levels of industry capacity.

Industry capacity can fluctuate as changing industry conditions can influence producers to idle production or permanently close machines or entire mills. In addition, to avoid substantial cash costs in idling or closing a mill, some producers will choose to operate at a loss, sometimes even a cash loss, which can prolong weak pricing environments due to oversupply. Oversupply of our products can also result from producers introducing new capacity in response to favorable pricing trends.

Demand for pulp has historically been determined by the level of economic growth and has been closely tied to overall business activity. From 2006 to mid-2008, pulp prices in Europe steadily improved. However, in the latter half of 2008, a global economic crisis resulted in a sharp decline of European pulp prices from a high of \$900 per ADMT to \$635 per ADMT at the end of 2008. Beginning in the second quarter of 2009 prices began to improve, rising from a low of \$575 per ADMT in March 2009 to \$980 per ADMT at the end of the second quarter of 2010. European list pulp prices remained at historically high levels through the second quarter of 2011.

Prices for pulp are driven by many factors outside our control, and we have little influence over the timing and extent of price changes, which are often volatile. Because market conditions beyond our control determine the price for pulp, such pulp may fall below our cash production costs, requiring us to either incur short-term losses on product sales or cease production at one or more of our mills. Therefore, our profitability depends on managing our cost structure, particularly raw materials which represent a significant component of our operating costs and can fluctuate based upon factors beyond our control. If the prices of our products decline, or if prices for our raw materials increase, or both, our results of operations could be materially adversely affected.

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*Costs*

Our production costs are influenced by the availability and cost of raw materials, energy and labor, and our plant efficiencies and productivity. Our main raw material is fiber in the form of wood chips and pulp logs. Fiber costs are primarily affected by the supply of, and demand for, lumber which is highly cyclical in nature and can vary significantly by location. The state of lumber markets affects both the amount of sawmill residuals, such as chips, produced as a by-product of lumber and the level of timber harvesting, which provides us with pulp logs. 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.

*Currency*

The majority of our sales are in products quoted in U.S. dollars while most of our operating costs and expenses, other than those of the Celgar mill, are incurred in Euros. In addition, all of the products sold by the Celgar mill are quoted in U.S. dollars and the Celgar mill costs are primarily incurred in Canadian dollars. Our results of operations and financial condition are reported in Euros. As a result, our revenues are adversely affected by a decrease in the value of the U.S. dollar relative to the Euro and to the Canadian dollar. Such shifts in currencies relative to the Euro and the Canadian dollar reduce our operating margins and the cash flow available to fund our operations and to service our debt. Conversely, an increase in the U.S. dollar versus the Euro and the Canadian dollar positively impacts our revenues by increasing our operating margins and cash flow.

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

We are exposed to market risks from changes in interest rates and foreign currency exchange rates, particularly the exchange rate between the Euro and the U.S. dollar and the Canadian dollar versus the U.S. dollar and the Euro. Changes in these rates may affect our results of operations and financial condition and, consequently, our fair value. We seek to manage these risks through internal risk management policies, as well as the use of derivatives. We use derivatives to reduce or limit our exposure to interest rate and, from time to time, 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 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 significant 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 observable inputs including applicable yield curves.

During the first six months of 2011, we recorded an unrealized gain of \$9.9 million on our outstanding interest rate derivatives compared to an unrealized loss of \$11.0 million in the comparative period of 2010.

We are also subject to some energy price risk, primarily for the electricity that our operations purchase.

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**ITEM 4. CONTROLS AND PROCEDURES**

*Disclosure Controls and Procedures.* Our management, with the participation of our principal executive officer and principal financial officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the *Securities Exchange Act of 1934*, as amended (the Exchange Act)), as of the end of the period covered by this report. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the reports we file or submit under the Exchange Act is accumulated and communicated to management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure. Based on such evaluation, our principal executive officer and principal financial officer have concluded that, as of the end of the period covered by this report, our disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by us in the reports that we file or submit under the Exchange Act.

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 changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

We are subject to routine litigation incidental to our business, including those described in our latest annual report on Form 10-K for the fiscal year ended December 31, 2010. 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 latest annual report on Form 10-K for the fiscal year ended December 31, 2010.

**ITEM 2. UNREGISTERED SALE OF EQUITY SECURITIES AND USE OF PROCEEDS**

None.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

<b>Exhibit No.</b>	<b>Description</b>
10.1	Amended and Restated Credit Agreement among Zellstoff Celgar Limited Partnership, as Borrower, and the Lenders from time to time parties thereto, as Lenders and CIT Business Credit Canada Inc., as Agent.
31.1	Section 302 Certification of Chief Executive Officer
31.2	Section 302 Certification of Chief Financial Officer
32.1*	Section 906 Certification of Chief Executive Officer
32.2*	Section 906 Certification of Chief Financial Officer

\* In accordance with Release 33-8212 of the Commission, these Certifications: (i) are furnished to the Commission and are not filed for the purposes of liability under the Securities Exchange Act of 1934, as amended; and (ii) are not to be subject to automatic incorporation by reference into any of the Company's registration statements filed under the Securities Act of 1933, as amended for the purposes of liability thereunder or any offering memorandum, unless the Company specifically incorporates them by reference therein.

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**SIGNATURES**

Pursuant to the requirements of the *Securities Exchange Act of 1934*, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**MERCER INTERNATIONAL INC.**

By: /s/ David M. Gandossi  
David M. Gandossi  
Secretary and Chief Financial Officer

Date: August 4, 2011  
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