

MERCER INTERNATIONAL INC.

Form 10-Q

November 07, 2007

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

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

For the quarterly period ended September 30, 2007

OR

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

For the transition period from _____ to _____

Commission File No.: 000-51826

MERCER INTERNATIONAL INC.

(Exact name of Registrant as specified in its charter)

Washington

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

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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one): Large Accelerated Filer Accelerated Filer Non-Accelerated Filer

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

The Registrant had 36,285,027 shares of common stock outstanding as at November 6, 2007.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

MERCER INTERNATIONAL INC.

CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2007

(Unaudited)

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MERCER INTERNATIONAL INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)
(Euros in thousands)

	September 30, 2007	December 31, 2006
ASSETS		
Current assets		
Cash and cash equivalents	69,441	69,367
Receivables	97,380	75,022
Note receivable, current portion	5,998	7,798
Inventories (Note 4)	96,791	62,857
Prepaid expenses and other	6,356	4,662
Current assets of discontinued operations (Note 10)	1,537	2,094
Total current assets	277,503	221,800
Long-term assets		
Cash, restricted	33,000	57,000
Property, plant and equipment	949,046	972,143
Investments	72	1
Unrealized foreign exchange rate derivative gain		5,933
Deferred note issuance and other costs	5,949	6,984
Deferred income tax	18,016	29,989
Note receivable, less current portion	4,239	8,744
	1,010,322	1,080,794
Total assets	1,287,825	1,302,594
LIABILITIES		
Current liabilities		
Accounts payable and accrued expenses	91,293	84,173
Debt, current portion	34,023	33,903
Current liabilities of discontinued operations (Note 10)	610	1,926
Total current liabilities	125,926	120,002
Long-term liabilities		
Debt, less current portion (Note 8)	822,331	873,928
Unrealized interest rate derivative loss	23,266	41,355
Pension and other post-retirement benefit obligations (Note 6)	19,625	17,954
Capital leases	5,350	6,202
Deferred income tax	16,698	22,911
Other long-term liabilities	3,714	1,441
	890,984	963,791

Total liabilities	1,016,910	1,083,793
Minority interest		
SHAREHOLDERS EQUITY		
Common shares (Note 8)	202,845	195,642
Additional paid-in capital	134	154
Retained earnings	30,181	15,240
Accumulated other comprehensive income	37,755	7,765
Total shareholders equity	270,915	218,801
Total liabilities and shareholders equity	1,287,825	1,302,594

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

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MERCER INTERNATIONAL INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(Euros in thousands, except for income per share)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2007	2006	2007	2006
Revenues	191,111	171,248	537,245	463,510
Costs and expenses				
Operating costs	149,440	117,186	429,637	358,740
Operating depreciation and amortization	14,284	13,465	42,003	41,790
	27,387	40,597	65,605	62,980
General and administrative expenses	5,930	5,839	19,494	19,891
(Sale) purchase of emission allowances			(766)	(13,246)
Operating income from continuing operations	21,457	34,758	46,877	56,335
Other income (expense)				
Interest expense	(18,599)	(23,041)	(56,308)	(68,769)
Investment income	2,791	1,080	5,986	4,083
Unrealized foreign exchange gain (loss) on debt	4,626	(704)	7,229	11,469
Realized gain (loss) on derivative instruments (Note 5)			6,820	(5,219)
Unrealized (loss) gain on derivative instruments (Note 5)	(5,696)	(14,473)	12,156	76,251
Total other (expense) income	(16,878)	(37,138)	(24,117)	17,815
Income (loss) before income taxes and minority interest from continuing operations	4,579	(2,380)	22,760	74,150
Income tax benefit (provision) current	(144)	(302)	(877)	(524)
deferred	7,013	2,834	(5,959)	(39,864)
Income before minority interest from continuing operations	11,448	152	15,924	33,762
Minority interest	(742)	5,976	(785)	6,874
Net income from continuing operations	10,706	6,128	15,139	40,636
Net (loss) income from discontinued operations	(10)	600	(198)	1,101
Net income	10,696	6,728	14,941	41,737
Retained earnings (deficit), beginning of period	19,485	(12,961)	15,240	(47,970)

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Retained earnings (deficit), end of period	30,181	(6,233)	30,181	(6,233)
Net income per share from continuing operations (Note 3)				
Basic	0.30	0.18	0.42	1.22
Diluted	0.26	0.18	0.40	1.03
Income per share				
Basic	0.29	0.20	0.41	1.26
Diluted	0.26	0.19	0.39	1.05

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

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MERCER INTERNATIONAL INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)
(Euros in thousands)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2007	2006	2007	2006
Net income	10,696	6,728	14,941	41,737
Other comprehensive income:				
Foreign currency translation adjustment	11,665	(943)	29,919	4,417
Pension plan additional minimum liability		(3)		(20)
Unrealized (losses) gains on securities	(16)	22	71	712
Other comprehensive income (loss)	11,649	(924)	29,990	5,109
Total comprehensive income	22,345	5,804	44,931	46,846

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

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MERCER INTERNATIONAL INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(Euros in thousands)

	Nine Months Ended	
	September 30,	
	2007	2006
Cash flows from operating activities:		
Net income	14,941	41,737
Adjustments to reconcile net income to cash flows from operating activities		
Unrealized gains on derivatives	(12,156)	(71,032)
Unrealized foreign exchange gain on debt	(7,229)	(11,469)
Loss (gain) on sale of assets	128	(359)
Operating depreciation and amortization	42,003	42,815
Non-operating amortization	194	205
Minority interest	785	(6,874)
Deferred income taxes	5,959	39,878
Stock compensation expense	350	293
Pension and other post-retirement expense	1,366	1,297
Other	912	14
Changes in current assets and liabilities		
Receivables	(19,314)	(14,936)
Inventories	(31,149)	11,940
Accounts payable and accrued expenses	5,610	(136)
Other	1,939	(106)
Net cash from operating activities	4,339	33,267
Cash flows from (used in) investing activities:		
Cash restricted	24,000	(25,388)
Purchase of property, plant and equipment ⁽¹⁾	(2,704)	(23,978)
Proceeds on sale of property, plant and equipment	538	5,000
Notes receivable	4,720	
Pension and other post-retirement benefit funding	(1,201)	(1,352)
Net cash from (used in) investing activities	25,353	(45,718)
Cash flows used in financing activities:		
Decrease in construction costs payable		(270)
Proceeds from borrowings of notes payable and debt		77,300
Proceeds from minority shareholders		5,463
Repayment of notes payable and debt	(26,865)	(80,906)
Proceeds from investment grants		383
Repayment of capital lease obligations	(4,222)	(3,263)
Issuance of shares of common stock	305	145

Net cash used in financing activities	(30,782)	(1,148)
Effect of exchange rate changes on cash and cash equivalents	1,764	(575)
Net increase (decrease) in cash and cash equivalents	674	(14,174)
Cash and cash equivalents, beginning of period ⁽²⁾	69,804	83,547
Cash and cash equivalents, end of period ⁽³⁾	70,478	69,373

(1) Includes amounts received and recorded as a reduction of property, plant and equipment (approximately 9,100) upon the settlement of the Stendal engineering, procurement and construction (EPC) contract.

(2) Includes amounts related to discontinued operations of: 2007 437 (2006 772) (Note 10)

(3) Includes amounts related to discontinued operations of: 2007 1,037 (2006 428) (Note 10)

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

MERCER INTERNATIONAL INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)
(Unaudited)
(Euros in thousands)

	Nine Months Ended September 30,	
	2007	2006
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	66,136	75,996
Income taxes	397	310
Supplemental schedule of non-cash investing and financing activities:		
Acquisition of production and other equipment under capital lease obligations	2,088	3,465
Common shares issued in satisfaction of floating rate note	6,728	

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

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

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

Note 1. Basis of Presentation

Basis of Presentation

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

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

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

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

Note 1. Basis of Presentation (continued)

New Accounting Standards

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (FAS 157). FAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. It is applicable whenever another standard requires or permits assets or liabilities to be measured at fair value, but it does not expand the use of fair value to any new circumstances. FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is in the process of determining the impact, if any, the adoption of FAS 157 will have on its consolidated financial position or results of operations.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (FAS 159). FAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value, with the objective of improving financial reporting by mitigating volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The provisions of FAS 159 are effective for the Company s year ending December 31, 2008. The Company is currently evaluating the impact, if any, that the adoption of this statement will have on the Company s consolidated financial position, results of operations and disclosures.

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

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

Note 2. Stock-Based Compensation

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

Stock Options

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

Following is a summary of the status of options outstanding at September 30, 2007:

Exercise Price Range (In U.S. Dollars)	Outstanding Options			Exercisable Options	
	Number	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise price (In U.S. Dollars)	Number	Weighted Average Exercise Price (In U.S. Dollars)
\$5.65-6.375	830,000	2.75	\$ 6.29	830,000	\$ 6.29
7.30	30,000	7.75	7.30	30,000	7.30
7.92	68,334	8.00	7.92	68,334	7.92

During the three month period ended September 30, 2007, no options were exercised or cancelled while 135,000 options expired. During the nine month period ended September 30, 2007, 30,000 options were exercised at an exercise price of \$6.375 and 26,666 options were exercised at an exercise price of \$7.92 for cash proceeds of \$402,435. 5,000 options were cancelled during the period, and 135,000 options expired during the period. The average intrinsic value of the options exercised was \$4.58 per option. During the nine month period ended September 30, 2006, no options were exercised, cancelled or expired.

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

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

Note 2. Stock-Based Compensation (continued)

Restricted Stock

The fair value of restricted stock is determined based upon the number of shares granted and the quoted price of the Company's stock on the date of grant. Restricted stock generally vests over two years. Expense is recognized on a straight-line basis over the vesting period. Expense recognized for the three and nine month periods ended September 30, 2007 were 88 (2006 85) and 231 (2006 - 292), respectively.

As at September 30, 2007, the total remaining unrecognized compensation cost related to restricted stock amounted to 173, which will be amortized over their remaining vesting period.

During the three and nine month periods ended September 30, 2007, there were restricted stock awards granted of an aggregate of 21,000 (2006 10,000) and 21,000 (2006 20,000), respectively, of our common shares to independent directors and officers of the Company. During the nine month period ended September 30, 2007 and 2006, no restricted stock awards were cancelled.

As at September 30, 2007, the total number of restricted stock awards outstanding was 211,686.

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

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

Note 3. Income Per Share

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2007	2006	2007	2006
Net income from continuing operations basic	10,706	6,128	15,139	40,636
Interest on convertible notes, net of tax	1,050	1,810	2,956	4,576
Net income from continuing operations diluted	11,756	7,938	18,095	45,212
Net income from continuing operations per share:				
Basic	0.30	0.18	0.42	1.22
Diluted	0.26	0.18	0.40	1.03
Net income from continuing operations	10,706	6,128	15,139	40,636
Net (loss) income from discontinued operations	(10)	600	(198)	1,101
Net income basic	10,696	6,728	14,941	41,737
Interest on convertible notes, net of tax	1,050	1,810	2,956	4,576