

MERCER INTERNATIONAL INC.

Form 10-Q

July 31, 2008

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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, 2008**

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, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

(Do not check if a 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 36,422,487 shares of common stock outstanding as at July 30, 2008.

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**PART I. FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**MERCER INTERNATIONAL INC.  
INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE SIX MONTHS ENDED JUNE 30, 2008  
(Unaudited)**

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

|  | <b>June 30,<br/>2008</b> | <b>December<br/>31,<br/>2007</b> |
|--|--------------------------|----------------------------------|
| <b>ASSETS</b>  |                          |                                  |
| Current assets   |                          |                                  |
| Cash and cash equivalents  | 83,295                   | 84,848                           |
| Receivables  | 98,181                   | 89,890                           |
| Note receivable, current portion                                       | 557                      | 5,896                            |
| Inventories (Note 4)   | 106,360                  | 103,610                          |
| Prepaid expenses and other   | 6,485                    | 6,015                            |
| Total current assets   | 294,878                  | 290,259                          |
| Long-term assets   |                          |                                  |
| Cash, restricted   | 33,000                   | 33,000                           |
| Property, plant and equipment  | 897,377                  | 933,258                          |
| Investments  | 778                      | 96                               |
| Deferred note issuance and other costs                                 | 4,640                    | 5,303                            |
| Deferred income tax  | 12,202                   | 17,624                           |
| Note receivable, less current portion                                  | 3,406                    | 3,977                            |
|  | 951,403                  | 993,258                          |
| Total assets   | 1,246,281                | 1,283,517                        |
| <b>LIABILITIES</b>   |                          |                                  |
| Current liabilities  |                          |                                  |
| Accounts payable and accrued expenses                                  | 89,914                   | 87,000                           |
| Pension and other post-retirement benefit obligations, current portion | 438                      | 493                              |
| Debt, current portion  | 35,042                   | 34,023                           |
| Total current liabilities  | 125,394                  | 121,516                          |
| Long-term liabilities  |                          |                                  |
| Debt, less current portion   | 786,988                  | 815,832                          |
| Unrealized interest rate derivative losses                             | 9,155                    | 21,885                           |
| Pension and other post-retirement benefit obligations (Note 6)         | 17,450                   | 19,983                           |
| Capital leases and other   | 11,534                   | 8,999                            |
| Deferred income tax  | 22,361                   | 18,640                           |
|  | 847,488                  | 885,339                          |
| Total liabilities  | 972,882                  | 1,006,855                        |

**SHAREHOLDERS EQUITY**

|   |           |           |
|---|-----------|-----------|
| Share capital (Note 7)                    | 203,600   | 202,844   |
| Additional paid-in capital                | 445       | 134       |
| Retained earnings                         | 41,159    | 37,419    |
| Accumulated other comprehensive income    | 28,195    | 36,265    |
| Total shareholders equity                 | 273,399   | 276,662   |
| Total liabilities and shareholders equity | 1,246,281 | 1,283,517 |

*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>2008</b>               | <b>2007</b> | <b>2008</b>             | <b>2007</b> |
| Revenues  | 170,585                   | 176,603     | 349,686                 | 346,134     |
| Costs and expenses  |                           |             |                         |             |
| Operating costs   | 142,902                   | 143,658     | 282,343                 | 278,302     |
| Operating depreciation and amortization                                     | 13,514                    | 13,990      | 27,635                  | 27,719      |
|   | 14,169                    | 18,995      | 39,708                  | 40,113      |
| Selling, general and administrative expenses                                | 7,953                     | 8,051       | 14,849                  | 15,459      |
| (Sale) purchase of emission allowances                                      |                           | (39)        |                         | (766)       |
| Operating income from continuing operations                                 | 6,216                     | 10,943      | 24,859                  | 25,420      |
| Other income (expense)  |                           |             |                         |             |
| Interest expense  | (16,013)                  | (17,641)    | (32,633)                | (37,709)    |
| Investment income   | 1,421                     | 1,584       | 1,731                   | 3,195       |
| Foreign exchange gain on debt   | 238                       | 1,349       | 6,269                   | 2,603       |
| Realized gain on derivative instruments (Note 5)                            |                           |             |                         | 6,820       |
| Unrealized gain on derivative instruments (Note 5)                          | 20,580                    | 18,100      | 12,730                  | 17,852      |
| Total other income (expense)  | 6,226                     | 3,392       | (11,903)                | (7,239)     |
| Income before income taxes and minority interest from continuing operations | 12,442                    | 14,335      | 12,956                  | 18,181      |
| Income tax benefit (provision) current                                      | (213)                     | (384)       | 163                     | (733)       |
| deferred  | (7,922)                   | (9,520)     | (9,126)                 | (12,972)    |
| Income before minority interest from continuing operations                  | 4,307                     | 4,431       | 3,993                   | 4,476       |
| Minority interest   | (3,436)                   | (1,091)     | (253)                   | (43)        |
| Net income from continuing operations                                       | 871                       | 3,340       | 3,740                   | 4,433       |
| Net loss from discontinued operations                                       |                           | (181)       |                         | (188)       |
| Net income  | 871                       | 3,159       | 3,740                   | 4,245       |
| Retained earnings, beginning of period                                      | 40,288                    | 16,326      | 37,419                  | 15,240      |
| Retained earnings, end of period  | 41,159                    | 19,485      | 41,159                  | 19,485      |

Net income from continuing operations per share

(Note 3):

|                   |      |      |      |      |
|-------------------|------|------|------|------|
| Basic and diluted | 0.02 | 0.09 | 0.10 | 0.12 |
|-------------------|------|------|------|------|

Net income per share:

|                   |      |      |      |      |
|-------------------|------|------|------|------|
| Basic and diluted | 0.02 | 0.09 | 0.10 | 0.12 |
|-------------------|------|------|------|------|

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

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**MERCER INTERNATIONAL INC.**  
**INTERIM CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME**  
**(Unaudited)**  
**(In thousands of Euros)**

|   | <b>Three Months Ended</b> |             | <b>Six Months Ended</b> |             |
|---|---------------------------|-------------|-------------------------|-------------|
|   | <b>June 30,</b>           |             | <b>June 30,</b>         |             |
|   | <b>2008</b>               | <b>2007</b> | <b>2008</b>             | <b>2007</b> |
| Net income  | 871                       | 3,159       | 3,740                   | 4,245       |
| Other comprehensive income:                                       |                           |             |                         |             |
| Foreign currency translation adjustment                           | 2,056                     | 16,350      | (8,048)                 | 18,254      |
| Unrealized (losses) gains on securities arising during the period | 3                         | 85          | (22)                    | 87          |
| Other comprehensive (loss) income                                 | 2,059                     | 16,435      | (8,070)                 | 18,341      |
| Total comprehensive (loss) income                                 | 2,930                     | 19,594      | (4,330)                 | 22,586      |

*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>2008</b>               | <b>2007</b> | <b>2008</b>             | <b>2007</b> |
| Cash flows from (used in) operating activities:                             |                           |             |                         |             |
| Net income  | 871                       | 3,159       | 3,740                   | 4,245       |
| Adjustments to reconcile net income to cash flows from operating activities |                           |             |                         |             |
| Unrealized gains on derivatives   | (20,580)                  | (18,100)    | (12,730)                | (17,852)    |
| Unrealized foreign exchange gain on debt                                    | (238)                     | (1,349)     | (6,269)                 | (2,603)     |
| Loss (gain) on sale of assets   | 64                        | 69          | (958)                   | (23)        |
| Operating depreciation and amortization                                     | 13,514                    | 13,990      | 27,635                  | 27,719      |
| Non-operating amortization  | 70                        | 65          | 141                     | 128         |
| Minority interest   | 3,436                     | 1,091       | 253                     | 43          |
| Deferred income taxes   | 7,922                     | 9,520       | 9,126                   | 12,972      |
| Stock compensation expense  | 207                       | (37)        | 355                     | 196         |
| Pension and other post-retirement expense                                   | 491                       | 506         | 1,006                   | 955         |
| Pension and other post-retirement benefit funding                           | (676)                     | (443)       | (1,125)                 | (833)       |
| Other   | (427)                     | 646         | (486)                   | 947         |
| Changes in current assets and liabilities                                   |                           |             |                         |             |
| Receivables   | (6,845)                   | (4,989)     | (10,678)                | (26,721)    |
| Inventories   | (8,389)                   | (9,720)     | (7,683)                 | (29,670)    |
| Accounts payable and accrued expenses                                       | 17,181                    | 8,958       | 5,801                   | 15,129      |
| Other   | (796)                     | 147         | 1,301                   | 1,280       |
| Net cash from (used in) operating activities                                | 5,805                     | 3,513       | 9,429                   | (14,088)    |
| Cash flows from (used in) investing activities:                             |                           |             |                         |             |
| Purchase of property, plant and equipment                                   | (4,859)                   | (4,512)     | (7,861)                 | (10,537)    |
| Proceeds on sale of property, plant and equipment                           | 653                       | 417         | 1,613                   | 527         |
| Cash restricted   |                           |             |                         | 12,000      |
| Notes receivable  | 5,303                     | 4,463       | 5,303                   | 4,731       |
| Net cash from (used in) investing activities                                | 1,097                     | 368         | (945)                   | 6,721       |
| Cash flows from (used in) financing activities:                             |                           |             |                         |             |
| Repayment of notes payable and debt   |                           | (1,232)     | (16,891)                | (13,453)    |
| Repayment of capital lease obligations                                      | (194)                     | (1,392)     | (832)                   | (2,576)     |
| Decrease in construction costs payable                                      |                           | 907         |                         |             |
| Proceeds from borrowings of notes payable and debt                          | 8,431                     |             | 8,431                   |             |
| Issuance of common shares   |                           | 59          |                         | 305         |
| Net cash from (used in) financing activities                                | 8,237                     | (1,658)     | (9,292)                 | (15,724)    |

|   |         |        |         |          |
|---|---------|--------|---------|----------|
| Effect of exchange rate changes on cash and cash equivalents  | (1,579) | 1,206  | (745)   | 2,171    |
| Net decrease in cash and cash equivalents                     | 13,560  | 3,429  | (1,553) | (20,920) |
| Cash and cash equivalents, beginning of period <sup>(1)</sup> | 69,735  | 45,455 | 84,848  | 69,804   |
| Cash and cash equivalents, end of period <sup>(2)</sup>       | 83,295  | 48,884 | 83,295  | 48,884   |

(1) Includes amounts related to discontinued operations of:  
2008 nil (2007 437)

(2) Includes amounts related to discontinued operations of:  
2008 nil (2007 582)

*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>2008</b>               | <b>2007</b> | <b>2008</b>             | <b>2007</b> |
| Supplemental disclosure of cash flow information:                             |                           |             |                         |             |
| Cash paid (received) during the period for:                                   |                           |             |                         |             |
| Interest  | 4,280                     | 7,230       | 30,766                  | 17,624      |
| Income taxes  | (332)                     |             | (318)                   | 615         |
| Supplemental schedule of non-cash investing and financing activities:         |                           |             |                         |             |
| Acquisition of production and other equipment under capital lease obligations | 977                       | 196         | 3,699                   | 2,215       |
| Common shares issued in satisfaction of floating rate note                    |                           |             |                         | 6,728       |

*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. Basis of Presentation**

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

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. 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, 2007. 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 operating 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 unaudited interim consolidated financial statements have been reclassified to conform to the current year presentation.

*New Accounting Standards*

In February 2007, the Financial Accounting Standards Board ( 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. FAS 159 is intended to improve 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 Company adopted FAS 159 effective January 1, 2008, the impact of which was not material.

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

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

**Note 1. Basis of Presentation (cont d)**

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, *Disclosures about Derivative Instruments and Hedging Activities* ( FAS 161 ). FAS 161 requires enhanced disclosures about how and why companies use derivatives, how derivative instruments and related hedged items are accounted for and how derivative instruments and related hedged items affect a company's financial position, financial performance and cash flows. The provisions of FAS 161 are effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early adoption encouraged. Consequently, FAS 161 will be effective for the Company's quarter ended March 31, 2009. The Company is in the process of determining the impact, if any, the adoption of FAS 161 will have on its financial statement disclosures.

In May 2008, the FASB issued Statement of Financial Accounting Standards No. 162, *The Hierarchy of Generally Accepted Accounting Principles* ( FAS 162 ). FAS 162 defines the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements that are presented in conformity with generally accepted accounting principles in the United States. The provisions of FAS 162 are effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendment to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*. The Company is in the process of determining the impact, if any, the adoption of FAS 162 will have on its financial statements and disclosures.

In May 2008, the FASB issued FASB Staff Position APB 14-1 *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Settlement)* ( FSP 14-1 ). FSP 14-1 states that convertible debt instruments that are within its scope are required to be separated into both a debt component and an equity component. In addition, any debt discount is to be accreted to interest expense over the expected life of the debt. The provisions of FSP 14-1 are effective for financial statements issued for fiscal years beginning after December 15, 2008, and implementation is generally required to be retrospective. Early adoption is not permitted. The Company is in the process of determining the impact, if any, the adoption of FSP 14-1 will have on its financial statements and disclosures.

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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**

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. During the first quarter of 2008, the Company implemented a new form of stock-based compensation called performance stock under its existing 2004 stock incentive plan.

*Stock Options*

Following is a summary of the status of options outstanding at June 30, 2008:

| Exercise<br>Price Range   | Outstanding Options |  |  | Exercisable Options |  |
|---------------------------|---------------------|--|--|---------------------|--|
|                           | Number              | Weighted<br>Average<br>Remaining<br>Contractual<br>Life<br>(Years) | Weighted<br>Average<br>Exercise<br>price<br>(In U.S.<br>Dollars) | Number              | Weighted<br>Average<br>Exercise<br>Price<br>(In U.S.<br>Dollars) |
| <b>0(In U.S. Dollars)</b> |                     |  |  |                     |  |
| \$5.65 - 6.375            | 830,000             | 2.00   | \$ 6.29  | 830,000             | \$ 6.29  |
| 7.30                      | 30,000              | 7.00   | 7.30   | 30,000              | 7.30   |
| 7.92                      | 68,334              | 7.25   | 7.92   | 68,334              | 7.92   |

During the three and six month periods ended June 30, 2008, no options were exercised, cancelled or expired.

During the six month period ended June 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. The average intrinsic value of the options exercised was \$4.58 per option.

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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)**

*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 six months ended June 30, 2008 was 52 and 101, respectively (2007 68 and 143).

As at June 30, 2008, the total remaining unrecognized compensation cost related to restricted stock amounted to approximately 114, which will be amortized over their remaining vesting period.

During the three and six month periods ended June 30, 2008, 21,000 (2007 nil) restricted stock awards were granted to independent directors and officers of the Company and nil restricted stock awards were cancelled.

As at June 30, 2008, the total number of restricted stock awards outstanding was 232,685.

*Performance Stock*

Grants of performance stock comprise rights to receive stock at a future date that are contingent on the Company and the grantee achieving certain performance objectives. During the six months ended June 30, 2008, potential stock based performance awards totaled 570,615 shares, which vest on December 31, 2010. Expense recognized for the three and six month periods ended June 30, 2008, was 155 and 254, respectively (2007 nil and nil).

As at June 30, 2008, the total remaining unrecognized compensation cost associated with the performance stock totaled approximately 1,693, which will be amortized over their remaining vesting period.

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

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

**Note 3. Income Per Share**

|   | <b>Three Months Ended</b> |             | <b>Six Months Ended</b> |             |
|---|---------------------------|-------------|-------------------------|-------------|
|   | <b>June 30,</b>           |             | <b>June 30,</b>         |             |
|   | <b>2008</b>               | <b>2007</b> | <b>2008</b>             | <b>2007</b> |
| Net income from continuing operations basic and diluted | 871                       | 3,340       | 3,740                   | 4,433       |
| Net income from continuing operations per share:        |                           |             |                         |             |
| Basic and diluted                                       | 0.02                      | 0.09        | 0.10                    | 0.12        |
| Net income from continuing operations                   | 871                       | 3,340       | 3,740                   | 4,433       |
| Net loss from discontinued operations                   |                           | (181)       |                         | (188)       |
| Net income basic and diluted                            | 871                       | 3,159       | 3,740                   | 4,245       |
| Net income per share:                                   |                           |             |                         |             |
| Basic and diluted                                       | 0.02                      | 0.09        | 0.10                    | 0.12        |
| Weighted average number of common shares outstanding:   |                           |             |                         |             |
| Basic   | 36,405,641                | 36,256,472  | 36,371,569              | 35,873,800  |
| Effect of dilutive instruments:                         |                           |             |                         |             |
| Stock options and awards                                | 131,817                   | 437,715     | 141,689                 | 465,146     |
| Diluted   | 36,537,458                | 36,694,187  | 36,513,258              | 36,338,946  |

The calculation of diluted income per share does not include the exercise of instruments that would have an anti-dilutive effect on earnings per share.

Convertible notes excluded from the calculation of diluted income per share for the three and six month periods ended June 30, 2008 because they are anti-dilutive represented 8,678,065 (2007 - 9,428,022). Performance rights excluded from the calculation of diluted income per share for both the three and six month periods ended June 30, 2008 because they are anti-dilutive represented 285,297 (2007 - nil).

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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,<br/>2008</b> | <b>December 31,<br/>2007</b> |
|---------------------------|--------------------------|------------------------------|
| Raw materials             | 30,813                   | 38,045                       |
| Finished goods            | 52,164                   | 43,127                       |
| Work in process and other | 23,383                   | 22,438                       |
|                           | 106,360                  | 103,610                      |

**Note 5. Derivatives Transactions**

|   | <b>Three Months Ended June<br/>30,</b> |             |
|---|--|-------------|
|   | <b>2008</b>                            | <b>2007</b> |
| Realized net gain on foreign exchange derivatives       |  |             |
| Unrealized net gain on interest rate derivatives        | 20,580                                 | 18,100      |
| Unrealized net loss on foreign exchange derivatives     |  |             |
| Unrealized net gain on derivative financial instruments | 20,580                                 | 18,100      |
|   |  |             |
|   | <b>Six Months Ended June<br/>30,</b>   |             |
|   | <b>2008</b>                            | <b>2007</b> |
| Realized net gain on foreign exchange derivatives       |  | 6,820       |
| Unrealized net gain on interest rate derivatives        | 12,730                                 | 23,786      |
| Unrealized net loss on foreign exchange derivatives     |  | (5,934)     |
| Unrealized net gain on derivative financial instruments | 12,730                                 | 17,852      |

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**(Unaudited)**

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

**Note 6. Pension and Other Post-Retirement Benefit Obligations**

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

The largest component of this obligation is with respect to the Celgar mill which maintains defined benefit pension and post-retirement benefit plans for certain employees. Pension benefits are based on employees' earnings and years of service. The pension plans are funded by contributions from the Company based on actuarial estimates and statutory requirements. Pension contributions for the three and six month periods ended June 30, 2008 totaled 383 and 831, respectively (2007 443 and 833).

The Company anticipates based on actuarial estimates that it will make contributions to the pension plan of approximately 1,195 (C\$1.8 million) in 2008.

|                                | <b>Three Months Ended June 30,</b> |  |                             |  |
|--------------------------------|------------------------------------|--|-----------------------------|--|
|                                | <b>2008</b>                        |  | <b>2007</b>                 |  |
|                                | <b>Pension<br/>Benefits</b>        | <b>Post-<br/>Retirement<br/>Benefits</b> | <b>Pension<br/>Benefits</b> | <b>Post-<br/>Retirement<br/>Benefits</b> |
| Service cost                   | 195                                | 124                                      | 209                         | 117                                      |
| Interest cost                  | 335                                | 198                                      | 339                         | 184                                      |
| Expected return on plan assets | (381)                              |  | (415)                       |  |
| Recognized net loss            |                                    | 20                                       |                             | 16                                       |
| Net periodic benefit cost      | 149                                | 342                                      | 133                         | 317                                      |

|                                | <b>Six Months Ended June 30,</b> |  |                             |  |
|--------------------------------|----------------------------------|--|-----------------------------|--|
|                                | <b>2008</b>                      |  | <b>2007</b>                 |  |
|                                | <b>Pension<br/>Benefits</b>      | <b>Post-<br/>Retirement<br/>Benefits</b> | <b>Pension<br/>Benefits</b> | <b>Post-<br/>Retirement<br/>Benefits</b> |
| Service cost                   | 399                              | 254                                      | 410                         | 230                                      |
| Interest cost                  | 686                              | 405                                      | 666                         | 362                                      |
| Expected return on plan assets | (780)                            |  | (815)                       |  |
| Recognized net loss            |                                  | 42                                       |                             | 31                                       |
| Net periodic benefit cost      | 305                              | 701                                      | 261                         | 623                                      |

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**Note 7. Share Capital**

*Authorized*

Preferred shares with U.S. \$1 par value issuable in series: 50,000,000 (2007 50,000,000)

Series A: 2,000,000 (2007 2,000,000)

Common shares with U.S. \$1 par value: 200,000,000 (2007 200,000,000)

*Issued and Outstanding*

Common shares 36,422,487 (2007 36,264,027)

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

**Note 8. Restricted Group Supplemental Disclosure**

The terms of the indenture governing our 9.25% senior unsecured notes require that we provide the results of operations and financial condition of Mercer International Inc. and our restricted subsidiaries under the indenture, collectively referred to as the Restricted Group. As at and during the three and six months ended June 30, 2008 and 2007, the Restricted Group was comprised of Mercer International Inc., certain holding subsidiaries and our Rosenthal and Celgar mills. The Restricted Group excludes the Stendal mill.

**Combined Condensed Balance Sheet**

|  | <b>June 30, 2008</b>        |                                      |                     |                               |
|--|-----------------------------|--------------------------------------|---------------------|-------------------------------|
|  | <b>Restricted<br/>Group</b> | <b>Unrestricted<br/>Subsidiaries</b> | <b>Eliminations</b> | <b>Consolidated<br/>Group</b> |
| <b>ASSETS</b>  |                             |                                      |                     |                               |
| Current  |                             |                                      |                     |                               |
| Cash and cash equivalents  | 70,151                      | 13,144                               |                     | 83,295                        |
| Receivables  | 47,978                      | 50,203                               |                     | 98,181                        |
| Note receivable, current portion                                       | 557                         |                                      |                     | 557                           |
| Inventories  | 64,451                      | 41,909                               |                     | 106,360                       |
| Prepaid expenses and other   | 4,612                       | 1,873                                |                     | 6,485                         |
| <b>Total current assets</b>  | <b>187,749</b>              | <b>107,129</b>                       |                     | <b>294,878</b>                |
| Cash, restricted   |                             | 33,000                               |                     | 33,000                        |
| Property, plant and equipment  | 358,250                     | 539,127                              |                     | 897,377                       |
| Other  | 5,414                       | 4                                    |                     | 5,418                         |
| Deferred income tax  | 9,122                       | 3,080                                |                     | 12,202                        |
| Due from unrestricted group  | 53,993                      |                                      | (53,993)            |                               |
| Note receivable, less current portion                                  | 3,406                       |                                      |                     | 3,406                         |
| <b>Total assets</b>  | <b>617,934</b>              | <b>682,340</b>                       | <b>(53,993)</b>     | <b>1,246,281</b>              |
| <b>LIABILITIES</b>   |                             |                                      |                     |                               |
| Current  |                             |                                      |                     |                               |
| Accounts payable and accrued expenses                                  | 49,922                      | 39,992                               |                     | 89,914                        |
| Pension and other post-retirement benefit obligations, current portion | 438                         |                                      |                     | 438                           |
| Debt, current portion  |                             | 35,042                               |                     | 35,042                        |
| <b>Total current liabilities</b>                                       | <b>50,360</b>               | <b>75,034</b>                        |                     | <b>125,394</b>                |
| Debt, less current portion   | 261,376                     | 525,612                              |                     | 786,988                       |
| Due to restricted group  |                             | 53,993                               | (53,993)            |                               |
| Unrealized derivative loss   |                             | 9,155                                |                     | 9,155                         |
| Pension and other post-retirement benefit obligations                  | 17,450                      |                                      |                     | 17,450                        |
| Capital leases and other   | 7,063                       | 4,471                                |                     | 11,534                        |
| Deferred income tax  | 6,374                       | 15,987                               |                     | 22,361                        |

|   |         |         |          |           |
|---|---------|---------|----------|-----------|
| Total liabilities                         | 342,623 | 684,252 | (53,993) | 972,882   |
| <b>SHAREHOLDERS EQUITY</b>                |         |         |          |           |
| Total shareholders equity (deficit)       | 275,311 | (1,912) |          | 273,399   |
| Total liabilities and shareholders equity | 617,934 | 682,340 | (53,993) | 1,246,281 |

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(In thousands of Euros, except per share data)

**Note 8. Restricted Group Supplemental Disclosure (continued)****Combined Condensed Balance Sheet**

|  | <b>December 31, 2007</b>    |                                      |                     |                               |
|--|-----------------------------|--------------------------------------|---------------------|-------------------------------|
|  | <b>Restricted<br/>Group</b> | <b>Unrestricted<br/>Subsidiaries</b> | <b>Eliminations</b> | <b>Consolidated<br/>Group</b> |
| <b>ASSETS</b>  |                             |                                      |                     |                               |
| Current  |                             |                                      |                     |                               |
| Cash and cash equivalents  | 59,371                      | 25,477                               |                     | 84,848                        |
| Receivables  | 37,482                      | 52,408                               |                     | 89,890                        |
| Note receivable, current portion                                       | 589                         | 5,307                                |                     | 5,896                         |
| Inventories  | 63,444                      | 40,166                               |                     | 103,610                       |
| Prepaid expenses and other   | 3,714                       | 2,301                                |                     | 6,015                         |
| <br>   |                             |                                      |                     |                               |
| Total current assets   | 164,600                     | 125,659                              |                     | 290,259                       |
| Cash, restricted   |                             | 33,000                               |                     | 33,000                        |
| Property, plant and equipment  | 385,569                     | 547,689                              |                     | 933,258                       |
| Other  | 5,399                       |                                      |                     | 5,399                         |
| Deferred income tax  | 10,852                      | 6,772                                |                     | 17,624                        |
| Due from unrestricted group  | 57,457                      |                                      | (57,457)            |                               |
| Note receivable, less current portion                                  | 3,977                       |                                      |                     | 3,977                         |
| <br>   |                             |                                      |                     |                               |
| Total assets   | 627,854                     | 713,120                              | (57,457)            | 1,283,517                     |
| <br>   |                             |                                      |                     |                               |
| <b>LIABILITIES</b>   |                             |                                      |                     |                               |
| Current  |                             |                                      |                     |                               |
| Accounts payable and accrued expenses                                  | 43,621                      | 43,379                               |                     | 87,000                        |
| Pension and other post-retirement benefit obligations, current portion | 493                         |                                      |                     | 493                           |
| Debt, current portion  |                             | 34,023                               |                     | 34,023                        |
| <br>   |                             |                                      |                     |                               |
| Total current liabilities  | 44,114                      | 77,402                               |                     | 121,516                       |
| Debt, less current portion   | 273,589                     | 542,243                              |                     | 815,832                       |
| Due to restricted group  |                             | 57,457                               | (57,457)            |                               |
| Unrealized derivative loss   |                             | 21,885                               |                     | 21,885                        |
| Pension and other post-retirement benefit obligations                  | 19,983                      |                                      |                     | 19,983                        |
| Capital leases and other   | 7,033                       | 1,966                                |                     | 8,999                         |
| Deferred income tax  | 4,553                       | 14,087                               |                     | 18,640                        |
| <br>   |                             |                                      |                     |                               |
| Total liabilities  | 349,272                     | 715,040                              | (57,457)            | 1,006,855                     |

**SHAREHOLDERS EQUITY**

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|   |         |         |          |           |
|---|---------|---------|----------|-----------|
| Total shareholders equity (deficit)       | 278,582 | (1,920) |          | 276,662   |
| Total liabilities and shareholders equity | 627,854 | 713,120 | (57,457) | 1,283,517 |

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**Note 8. Restricted Group Supplemental Disclosure (continued)****Combined Condensed Statements of Operations**

|  | <b>Three Months Ended June 30, 2008</b> |                                      |                     | <b>Consolidated<br/>Group</b> |
|--|---|--------------------------------------|---------------------|-------------------------------|
|  | <b>Restricted<br/>Group</b>             | <b>Unrestricted<br/>Subsidiaries</b> | <b>Eliminations</b> |                               |
| Revenues   | 97,694                                  | 72,891                               |                     | 170,585                       |
| Operating costs  | 87,938                                  | 54,964                               |                     | 142,902                       |
| Operating depreciation and amortization  | 6,774                                   | 6,740                                |                     | 13,514                        |
| Selling, general and administrative expenses                                       | 4,865                                   | 3,088                                |                     | 7,953                         |
| (Sale) purchase of emission allowances   |   |                                      |                     |                               |
|  | 99,577                                  | 64,792                               |                     | 164,369                       |
| Operating income (loss) from continuing operations                                 | (1,883)                                 | 8,099                                |                     | 6,216                         |
| Other income (expense)   |   |                                      |                     |                               |
| Interest expense   | (4,440)                                 | (10,614)                             | (959)               | (16,013)                      |
| Investment income (expense)  | (373)                                   | 835                                  | 959                 | 1,421                         |
| Foreign exchange gain (loss) on debt   | (248)                                   | 486                                  |                     | 238                           |
| Derivative financial instruments   |   | 20,580                               |                     | 20,580                        |
| Total other income (expense)   | (5,061)                                 | 11,287                               |                     | 6,226                         |
| Income (loss) before income taxes and minority interest from continuing operations | (6,944)                                 | 19,386                               |                     | 12,442                        |
| Income tax provision   | (1,303)                                 | (6,832)                              |                     | (8,135)                       |
| Income (loss) before minority interest from continuing operations                  | (8,247)                                 | 12,554                               |                     | 4,307                         |
| Minority interest  |   | (3,436)                              |                     | (3,436)                       |
| Net income (loss)  | (8,247)                                 | 9,118                                |                     | 871                           |
|  |   |                                      |                     |                               |
|  | <b>Three Months Ended June 30, 2007</b> |                                      |                     | <b>Consolidated<br/>Group</b> |
|  | <b>Restricted<br/>Group</b>             | <b>Unrestricted<br/>Subsidiary</b>   | <b>Eliminations</b> |                               |
| Revenues   | 104,307                                 | 72,296                               |                     | 176,603                       |

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|   |         |          |       |          |
|---|---------|----------|-------|----------|
| Operating costs   | 86,893  | 56,765   |       | 143,658  |
| Operating depreciation and amortization                                     | 6,975   | 7,015    |       | 13,990   |
| Selling, general and administrative expenses                                | 4,642   | 3,409    |       | 8,051    |
| (Sale) purchase of emission allowances                                      | (4)     | (35)     |       | (39)     |
|   | 98,506  | 67,154   |       | 165,660  |
| Operating income from continuing operations                                 | 5,801   | 5,142    |       | 10,943   |
| Other income (expense)  |         |          |       |          |
| Interest expense  | (6,961) | (11,606) | 926   | (17,641) |
| Investment income   | 1,136   | 1,374    | (926) | 1,584    |
| Foreign exchange gain on debt   | 1,009   | 340      |       | 1,349    |
| Derivative financial instruments, net                                       |         | 18,100   |       | 18,100   |
| Total other income (expense)  | (4,816) | 8,208    |       | 3,392    |
| Income before income taxes and minority interest from continuing operations | 985     | 13,350   |       | 14,335   |
| Income tax provision  | (1,612) | (8,292)  |       | (9,904)  |
| Income (loss) before minority interest from continuing operations           | (627)   | 5,058    |       | 4,431    |
| Minority interest   |         | (1,091)  |       | (1,091)  |
| Net income (loss) from continuing operations                                | (627)   | 3,967    |       | 3,340    |
| Net loss from discontinued operations                                       | (181)   |          |       | (181)    |
| Net income (loss)   | (808)   | 3,967    |       | 3,159    |

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

**Note 8. Restricted Group Supplemental Disclosure (continued)****Combined Condensed Statements of Operations**

|  | <b>Six Months Ended June 30, 2008</b> |                                      |                     |                               |
|--|---------------------------------------|--------------------------------------|---------------------|-------------------------------|
|  | <b>Restricted<br/>Group</b>           | <b>Unrestricted<br/>Subsidiaries</b> | <b>Eliminations</b> | <b>Consolidated<br/>Group</b> |
| Revenues   | 198,796                               | 150,890                              |                     | 349,686                       |
| Operating costs  | 165,594                               | 116,749                              |                     | 282,343                       |
| Operating depreciation and amortization  | 14,195                                | 13,440                               |                     | 27,635                        |
| Selling, general and administrative expenses                                   | 8,609                                 | 6,240                                |                     | 14,849                        |
| (Sale) purchase of emission allowances   |                                       |                                      |                     |                               |
|  | 188,398                               | 136,429                              |                     | 324,827                       |
| Operating income   | 10,398                                | 14,461                               |                     | 24,859                        |
| Other income (expense)   |                                       |                                      |                     |                               |
| Interest expense   | (11,152)                              | (21,481)                             |                     | (32,633)                      |
| Investment income  | 1,363                                 | 368                                  |                     | 1,731                         |
| Foreign exchange gain (loss) on debt   | 6,379                                 | (110)                                |                     | 6,269                         |
| Derivative financial instruments   |                                       | 12,730                               |                     | 12,730                        |
| Total other expense  | (3,410)                               | (8,493)                              |                     | (11,903)                      |
| Income before income taxes and minority interest<br>from continuing operations | 6,988                                 | 5,968                                |                     | 12,956                        |
| Income tax provision   | (3,457)                               | (5,506)                              |                     | (8,963)                       |
| Income before minority interest from continuing<br>operations                  | 3,531                                 | 462                                  |                     | 3,993                         |
| Minority interest  |                                       | (253)                                |                     | (253)                         |
| Net income   | 3,531                                 | 209                                  |                     | 3,740                         |

|                 | <b>Six Months Ended June 30, 2007</b> |                                    |                     |                               |
|-----------------|---------------------------------------|------------------------------------|---------------------|-------------------------------|
|                 | <b>Restricted<br/>Group</b>           | <b>Unrestricted<br/>Subsidiary</b> | <b>Eliminations</b> | <b>Consolidated<br/>Group</b> |
| Revenues        | 204,240                               | 141,894                            |                     | 346,134                       |
| Operating costs | 163,747                               | 114,555                            |                     | 278,302                       |

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|   |          |          |         |          |
|---|----------|----------|---------|----------|
| Operating depreciation and amortization                                     | 13,661   | 14,058   |         | 27,719   |
| Selling, general and administrative expenses                                | 8,705    | 6,754    |         | 15,459   |
| (Sale) purchase of emission allowances                                      | (268)    | (498)    |         | (766)    |
|   | 185,845  | 134,869  |         | 320,714  |
| Operating income from continuing operations                                 | 18,395   | 7,025    |         | 25,420   |
| Other income (expense)  |          |          |         |          |
| Interest expense  | (14,418) | (25,132) | 1,841   | (37,709) |
| Investment income   | 2,440    | 2,596    | (1,841) | 3,195    |
| Foreign exchange gain on debt   | 2,263    | 340      |         | 2,603    |
| Derivative financial instruments, net                                       |          | 24,672   |         | 24,672   |
| Total other income (expense)  | (9,715)  | 2,476    |         | (7,239)  |
| Income before income taxes and minority interest from continuing operations | 8,680    | 9,501    |         | 18,181   |
| Income tax provision  | (4,150)  | (9,555)  |         | (13,705) |
| Income (loss) before minority interest from continuing operations           | 4,530    | (54)     |         | 4,476    |
| Minority interest   |          | (43)     |         | (43)     |
| Net income (loss) from continuing operations                                | 4,530    | (97)     |         | 4,433    |
| Net loss from discontinued operations                                       | (188)    |          |         | (188)    |
| Net income (loss)   | 4,342    | (97)     |         | 4,245    |

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

In this document: (i) unless the context otherwise requires, references to we, our, us, the Company or Mercer mean Mercer International Inc. and its subsidiaries; (ii) references to Mercer Inc. mean the Company excluding its subsidiaries; (iii) information is provided as of June 30, 2008, 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; and (vi) ADMTs refers to air-dried metric tonnes.

We operate three NBSK pulp mills through our wholly owned subsidiaries, Rosenthal and Celgar, and our 70.6% owned subsidiary, Stendal, which have a consolidated annual production capacity of approximately 1.4 million ADMTs.

The following discussion and analysis of our results of operations and financial condition for the six and three months ended June 30, 2008 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, 2007 filed with the SEC.

**Results of Operations*****Three Months Ended June 30, 2008 Compared to Three Months Ended June 30, 2007***

Selected production, sales and exchange rate data for the three months ended June 30, 2008 and 2007 is as follows:

|  | <b>Three Months Ended June<br/>30,</b> |             |
|--|--|-------------|
|  | <b>2008</b>                            | <b>2007</b> |
| Pulp Production ( 000 ADMTs)                             | 356.8                                  | 326.4       |
| Scheduled Production Downtime ( 000 ADMTs)               | 15                                     | 37          |
| Pulp Sales ( 000 ADMTs)                                  | 347.3                                  | 337.0       |
| Revenues (in millions)                                   | 170.6                                  | 176.6       |
| NBSK pulp list prices in Europe (\$/ADMT)                | \$ 900                                 | \$ 783      |
| NBSK pulp list prices in Europe ( /ADMT)                 | 576                                    | 579         |
| Average pulp sales realizations ( /ADMT <sup>(1)</sup> ) | 485                                    | 518         |
| Average Spot Currency Exchange Rates                     |  |             |
| /(\$)  | 0.6401                                 | 0.7416      |
| C\$ / \$( <sup>2</sup> )                                 | 1.0099                                 | 1.0981      |
| C\$ / ( <sup>3</sup> )                                   | 1.5783                                 | 1.4810      |

(1) List price less discounts and commissions.

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

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

Revenues for the three months ended June 30, 2008 decreased by 3.4% to 170.6 million from 176.6 million in the comparative quarter of 2007, primarily due to the weak U.S. dollar

List prices for NBSK pulp in Europe were approximately 576 (\$900) per ADMT in the second quarter of 2008 and approximately 579 (\$783) in the second quarter of 2007. Increases in U.S. dollar list prices were more than offset by the weakening of the U.S. dollar versus the Euro.

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Pulp sales volume increased to 347,259 ADMTs in the second quarter of 2008 from 337,016 ADMTs in the comparative quarter of 2007 as all of our mills performed generally well.

Average pulp sales realizations decreased by 6.4% to 485 per ADMT in the second quarter of 2008 from 518 per ADMT in the second quarter of 2007, as the continued slumping dollar more than offset pulp price improvements.

Pulp production in the second quarter of 2008 increased to 356,819 ADMTs from 326,350 ADMTs in the same period of 2007, as all of our mills performed generally well. In the second quarter of 2008, we had a total of 11 days scheduled maintenance downtime at our mills, compared to 24 days in the same period last year.

At June 30, 2008, our pulp inventories increased by approximately 7.7%, compared to the end of the first quarter of 2008. Pulp inventories at our Celgar mill remained high and largely the same as at March 31, 2008 due to delays in shipments to China caused by a sustained shipment backlog at the Port of Vancouver. While this inventory is generally already committed to customer orders, we do not record the sale until the pulp is shipped. Pulp inventories increased at our Stendal mill, as slowing economies and tighter credit caused certain of its customers to delay purchases into the second half of 2008.

Operating costs and selling, general, administrative and other expenses in the second quarter of 2008 decreased marginally to 164.4 million from 165.7 million in the comparative quarter of 2007, although we incurred higher freight costs and warehousing expenses in connection with the shipment backlog at the Port of Vancouver.

On average, fiber costs decreased by approximately 2.9% in the second quarter of 2008 versus the same period in 2007. Our fiber costs in Germany declined in the current quarter from the comparative period of 2007 and are expected to remain stable in the short term because of lower demand from the European board industry. However, there is some uncertainty about Russian government tariffs, which are expected to reduce Russian wood exports to Europe and which may begin to exert upward pressure on pricing if Scandinavian producers, who traditionally import significant amounts of Russian wood, seek out alternative supply markets such as Germany.

At our Celgar mill fiber costs in the second quarter of 2008 were comparable to the same quarter of 2007 and the prior quarter. Fiber costs have remained consistent despite significant curtailments in sawmilling activity as a result of the faltering North American housing and lumber markets which have sharply decreased the availability of fiber. Recent fiber initiatives at our Celgar mill, such as new pulp log procurement arrangements and the addition of a second shift in the woodroom, have helped stabilize fiber supply to the mill and we believe will provide some pricing relief over the balance of the year.

We recorded no contribution to income from the sale of emission allowances for the three months ended June 30, 2008 as the applicable emissions certificates were not issued until after June 30. In the same period last year, we recorded only a negligible contribution to income as a result of weak markets and prices for the sale of emission allowances. In the second quarter of 2008, sales of surplus energy were approximately 20% higher than in the comparative quarter of 2007.

In June the German government approved amendments to the country's Renewable Energy Resources Act, its legislative framework for the promotion of electricity generation from renewable energy sources, including biomass. A key element of the Act is that public electric utilities give priority to electricity from renewable energy sources and pay a fixed tariff for a period of 20 years. The amount of tariff is generally dependent on the technology used, the year the installation was put into operation and the size of the plant. The Act is only applicable to installments with a capacity of 20MW or less, effectively excluding our Rosenthal and Stendal mills, as large industrial complexes, from the statutory scheme. The recent amendments to the Act, currently scheduled to take effect January 1, 2009, raise this capacity limit, permitting our German mills to participate in the program, and increases the tariff for biomass energy. As a result, once the amendments become effective, we currently expect to be able to materially increase the revenues from our sales of surplus energy in Germany.

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Operating depreciation and amortization decreased marginally to 13.5 million from 14.0 million in the comparative quarter of 2007.

For the second quarter of 2008, operating income decreased to 6.2 million from 10.9 million in the comparative quarter of 2007, as the generally positive performance of our mills was more than offset by the continued weakness in the U.S. dollar against the Euro.

Interest expense in the second quarter of 2008 decreased to 16.0 million from 17.6 million in the year ago period, primarily due to a lower level of borrowing.

We recorded an unrealized gain of 20.6 million before minority interests on our interest rate derivatives during the second quarter of 2008. In the comparative quarter of 2007, we recorded an unrealized gain of 18.1 million before minority interests on our then outstanding interest rate derivatives.

In the second quarter of 2008, we recorded a gain of 0.2 million on our foreign currency denominated debt, compared to a gain of 1.3 million in the same period of 2007.

In the second quarter of 2008, minority interest, representing the minority shareholder's proportionate interest in the Stendal mill, was 3.4 million, compared to 1.1 million in the second quarter of 2007.

We reported net income from continuing operations for the second quarter of 2008 of 0.9 million, or 0.02 per basic and diluted share. In the second quarter of 2007, we reported net income from continuing operations of 3.3 million, or 0.09 per basic and diluted share.

Operating EBITDA decreased to 19.8 million in the second quarter of 2008 from 25.0 million in the three months ended June 30, 2007.

Operating EBITDA is defined as operating income from continuing operations plus depreciation and amortization and non-recurring capital asset impairment charges. Management uses Operating EBITDA as a benchmark measurement of its own operating results, and as a benchmark relative to its competitors. Management considers it to be a meaningful supplement to operating income as a performance measure primarily because depreciation expense and non-recurring capital asset impairment charges are not an actual cash cost, and depreciation expense varies widely from company to company in a manner that management considers largely independent of the underlying cost efficiency of their operating facilities. In addition, we believe Operating EBITDA is commonly used by securities analysts, investors and other interested parties to evaluate our financial performance. Operating EBITDA does not reflect the impact of a number of items that affect our net income, including financing costs and the effect of derivative instruments. Operating EBITDA is not a measure of financial performance under GAAP, and should not be considered as an alternative to net income or income from operations as a measure of operational 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

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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) minority interests on our Stendal NBSK pulp mill operations; (v) the impact of realized or marked to market changes in our derivative positions, which can be substantial; and (vi) the impact of impairment charges against our investments or assets. Because of these limitations, Operating EBITDA should only be considered as a supplemental 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.

The following table provides a reconciliation of net income from continuing operations to Operating EBITDA for the periods indicated:

|   | <b>Three Months Ended<br/>June 30,</b> |             |
|---|--|-------------|
|   | <b>2008</b>                            | <b>2007</b> |
|   | <b>(in thousands)</b>                  |             |
| Net income from continuing operations       | 871                                    | 3,340       |
| Minority interest                           | 3,436                                  | 1,091       |
| Income taxes                                | 8,135                                  | 9,904       |
| Interest expense                            | 16,013                                 | 17,641      |
| Investment income                           | (1,421)                                | (1,584)     |
| Unrealized foreign exchange gain on debt    | (238)                                  | (1,349)     |
| Derivative financial instruments, net       | (20,580)                               | (18,100)    |
| Operating income from continuing operations | 6,216                                  | 10,943      |
| Add: Depreciation and amortization          | 13,584                                 | 14,055      |
| Operating EBITDA                            | 19,800                                 | 24,998      |

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**Table of Contents****Six Months Ended June 30, 2008 Compared to Six Months Ended June 30, 2007**

Selected production, sales and exchange rate data for the six months ended June 30, 2008 and 2007 is as follows:

|  | <b>Six Months Ended June 30,</b> |             |
|--|----------------------------------|-------------|
|  | <b>2008</b>                      | <b>2007</b> |
| Pulp Production ( 000 ADMTs)               | 717.7                            | 673.6       |
| Scheduled Production Downtime ( 000 ADMTs) | 17                               | 37          |
| Pulp Sales ( 000 ADMTs)                    | 695.4                            | 666.2       |
| Revenues (in millions)                     | 349.7                            | 346.1       |
| NBSK pulp list prices in Europe (\$/ADMT)  | \$ 890                           | \$ 770      |
| NBSK pulp list prices in Europe ( /ADMT)   | 581                              | 570         |
| Average pulp sales realizations ( /ADMT)   | 498                              | 515         |
| Average Spot Currency Exchange Rates       |                                  |             |
| /(\$)                                      | 0.6530                           | 0.7522      |
| C\$ / \$( <sup>2</sup> )                   | 1.0070                           | 1.1349      |
| C\$ / \$( <sup>3</sup> )                   | 1.5420                           | 1.5082      |

(1) List price less discounts and commissions.

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

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

Revenues for the six months ended June 30, 2008 increased to 349.7 million from 346.1 million in the comparative period of 2007, primarily due to higher pulp list prices which were in large part offset by the weak U.S. dollar.

List prices for NBSK pulp in Europe were approximately 581 (\$890) per ADMT in the first half of 2008 and approximately 570 (\$770) in the first half of 2007. Increases in U.S. dollar list prices were largely offset by the weakening of the U.S. dollar versus the Euro.

Pulp sales volume increased to 695,436 ADMTs in the first half of 2008 from 666,151 ADMTs in the first half of 2007.

Average pulp sales realizations were 498 per ADMT in the first half of 2008 compared to 515 per ADMT in the first half of 2007, as marginal pulp list price improvements were more than offset by the weakening of the U.S. dollar versus the Euro.

Pulp production in the first half of 2008 increased to 717,700 ADMTs from 673,606 ADMTs in the same period of 2007, as all of our mills performed generally well. In the first half of 2008, we had a total of 12 days scheduled

maintenance downtime at our mills, compared to 24 days in the same period last year.

As at June 30, 2008, our pulp inventories increased by approximately 100% and 7.7%, compared to the same time last year and at the end of the first quarter of 2008, respectively. Pulp inventories at our Celgar mill remained high and largely the same as at March 31, 2008 due to delays in shipments to China caused by a sustained backlog at the Port of Vancouver. While this inventory is generally already committed to customer orders, we do not record the sale until the pulp is shipped. Pulp inventories increased at our Stendal mill, as slowing economies and tighter credit caused certain of its customers to delay purchases into the second half of 2008.

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Operating costs and selling, general, administrative and other expenses in the first half of 2008 increased to 324.9 million from 321.5 million in the comparative period of 2007, as we incurred higher freight costs and warehousing expenses in connection with the shipment backlog at the Port of Vancouver.

On average, fiber costs decreased by approximately 5.6% in the first half of 2008 versus the same period in 2007. Our fiber costs in Germany declined in the first half of 2008 from the comparative period of 2007 and are expected to remain stable in the short term because of lower demand from the European board industry. However, there is some uncertainty about Russian government tariffs, which are expected to reduce Russian wood exports to Europe and which may begin to exert upward pressure on pricing if Scandinavian producers, who traditionally import significant amounts of Russian wood, seek out alternative supply markets such as Germany.

At our Celgar mill fiber costs were lower in the first half of 2008 compared to the same period of 2007 despite significant curtailments in sawmilling activity as a result of the faltering North American housing and lumber markets which have sharply decreased the availability of fiber. Recent fiber initiatives at our Celgar mill, such as new pulp log procurement arrangements and the addition of a second shift in the woodroom, have helped stabilize fiber supply to the mill and we believe will provide some pricing relief over the balance of the year.

We recorded no contribution to income from the sale of emission allowances for the six months ended June 30, 2008 as the applicable emissions certificates were not issued until after June 30. In the first half of 2007, we recorded only a negligible contribution to income as a result of weak markets and prices for the sale of emission allowances. In the first half of 2008, sales of surplus energy were approximately 11% higher than in the same period of 2007.

Operating depreciation and amortization remained largely unchanged at 27.6 million in each of the periods ended June 30, 2008 and 2007.

For the first half of 2008, operating income decreased marginally to 24.9 million from 25.4 million in the first half of 2007 as the generally positive performance of our mills was more than offset by the continued weakness in the U.S. dollar against the Euro.

Interest expense in the first half of 2008 decreased to 32.6 million from 37.7 million in the year ago period, primarily due to a lower level of borrowing.

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We recorded an unrealized gain of 12.7 million before minority interests on our interest rate derivatives during the first half of 2008. In the comparative period of 2007, we recorded a gain of 24.7 million before minority interests on our then outstanding derivatives, which included a realized gain of 6.8 million from the settlement of currency swaps. In the first half of 2008, we recorded a gain of 6.3 million on our foreign currency denominated debt as a result of the weakening of the U.S. dollar during the period, compared to a gain of 2.6 million in the first half of 2007.

In the first half of 2008, minority interest, representing the minority shareholder's proportionate interest in the Stendal mill, was 0.3 million, compared to a negligible amount in the same period of 2007.

We reported net income from continuing operations for the first half of 2008 of 3.7 million, or 0.10 per basic and diluted share. In the first half of 2007, we reported net income from continuing operations of 4.4 million, or 0.12 per basic and diluted share.

Operating EBITDA was 52.6 million in the first half of 2008 from 53.3 million in the six months ended June 30, 2007.

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, 2008 for additional information relating to Operating EBITDA.

The following table provides a reconciliation of net income from continuing operations to Operating EBITDA for the periods indicated:

|   | <b>Six Months Ended<br/>June 30,</b> |             |
|---|--------------------------------------|-------------|
|   | <b>2008</b>                          | <b>2007</b> |
|   | <b>(in thousands)</b>                |             |
| Net income from continuing operations       | 3,740                                | 4,433       |
| Minority interest                           | 253                                  | 43          |
| Income taxes                                | 8,963                                | 13,705      |
| Interest expense                            | 32,633                               | 37,709      |
| Investment income                           | (1,731)                              | (3,195)     |
| Unrealized foreign exchange gain on debt    | (6,269)                              | (2,603)     |
| Derivative financial instruments, net       | (12,730)                             | (24,672)    |
| <br>  |                                      |             |
| Operating income from continuing operations | 24,859                               | 25,420      |
| Add: Depreciation and amortization          | 27,776                               | 27,847      |
| <br>  |                                      |             |
| Operating EBITDA                            | 52,635                               | 53,267      |

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**Table of Contents****Liquidity and Capital Resources**

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

|                               | <b>As at<br/>June 30,<br/>2008</b> | <b>As at<br/>December 31,<br/>2007</b> |
|-------------------------------|------------------------------------|--|
|                               | <b>(in thousands)</b>              |  |
| <b>Financial Position</b>     |                                    |  |
| Cash and cash equivalents     | 83,295                             | 84,848                                 |
| Working capital               | 169,484                            | 168,743                                |
| Property, plant and equipment | 897,377                            | 933,258                                |
| Total assets                  | 1,246,281                          | 1,283,517                              |
| Long-term liabilities         | 847,488                            | 885,339                                |
| Shareholders' equity          | 273,399                            | 276,662                                |

As at June 30, 2008 and December 31, 2007, our cash and cash equivalents were 83.3 million and 84.8 million, respectively. We also had 33.0 million of restricted cash in a debt service account related to the financing for the Stendal mill at the end of the second quarter of 2008 and December 31, 2007. As at June 30, 2008, we had not drawn any amount under the 40.0 million Rosenthal revolving term credit facility and had drawn approximately 21.8 million under the C\$40.0 million Celgar revolving credit facility.

We expect to meet our interest and debt service obligations and the working and maintenance capital requirements for our operations from cash flow from operations, cash on hand and the two revolving working capital facilities for the Rosenthal and Celgar mills.

We currently expect to meet the capital requirements for the Stendal mill, including working capital, interest and principal service expenses through cash on hand, cash flow from operations and the Stendal Loan Facility ( Stendal Facility ). Pursuant to the Stendal Facility, Stendal established a restricted cash debt service reserve account, the target balance of which is the scheduled interest and principal payments for the ensuing year. Under the Stendal Facility, Stendal is currently restricted from making certain payments, including paying dividends to us and its other shareholder as it does not meet prescribed financial performance ratios and the debt service reserve account balance requirements.

**Operating Activities**

Operating activities in the first half of 2008 provided cash of 9.4 million, compared to using cash of 14.1 million in the comparative period of 2007. An increase in receivables used cash of 10.7 million in the first half of 2008, compared to 26.7 million in the comparative period of 2007. An increase in inventories used cash of 7.7 million in the first half of 2008, compared to an increase in inventories using cash of 29.7 in the same period of 2007.

Working capital is subject to cyclical operating needs, such as the timing of collections and sales and the payment of payables.

**Investing Activities**

Investing activities in the first half of 2008 used cash of 0.9 million. During the first half of 2008, planned capital expenditures used cash of 7.9 million while the sale of equipment and the redemption of a convertible note provided cash of 6.9 million. In the six months ended June 30,

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2007 investing activities provided cash of 6.7 million primarily due to a drawdown of funds in our debt service reserve account under the Stendal facility.

Capital expenditures used cash of 7.9 million and 10.5 million in the first half of 2008 and 2007, respectively.

***Financing Activities***

Financing activities used cash of 9.3 million in the six months ended June 30, 2008, as we paid 16.9 million scheduled repayments of indebtedness under the Stendal Facility in the first half of 2008. In the comparative period in 2007, financing activities used cash of 15.7 million primarily due to scheduled repayments of a portion of the Stendal Facility.

Other than the agreement for the purchase of a new turbo generator relating to the energy project at our Celgar mill which we entered into in April 2008, we have no material commitments to acquire assets or operating businesses. We anticipate that there will be acquisitions of businesses or commitments to projects in the future. To achieve our long-term goals of expanding our asset and earnings base through the acquisition of interests in companies and assets in the pulp and paper and related businesses, and organically through high return capital expenditures at our operating facilities, we will require substantial capital resources. The required necessary resources for such long-term goals will be generated from cash flow from operations, cash on hand, the sale of securities and/or assets, and borrowing against our assets.

***Contractual Obligations and Commitments***

There were no material changes outside the ordinary course to any of our contractual obligations during the first half of 2008.

***Capital Resources***

In addition to our current revolving credit facilities for the Rosenthal and Celgar mills, we may seek to raise future funding in the debt markets if our indenture relating to our 9.25% senior notes permits, subject to compliance with the indenture. The indenture governing the senior notes provides that, in order for Mercer Inc. and its restricted subsidiaries (as defined in the indenture and which excludes the Stendal mill) to enter into certain types of transactions, including the incurrence of additional indebtedness, the making of restricted payments and the completion of mergers and consolidations (other than, in each case, those specifically permitted by our senior note indenture), we must meet a minimum ratio of Indenture EBITDA to Fixed Charges as defined in the senior note indenture of 2.0 to 1.0 on a pro forma basis for the most recently ended four full fiscal quarters.

***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.

Unrealized gains or losses from these translations are recorded in our

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consolidated statement of comprehensive income and impact on shareholders' equity on the balance sheet but do not affect our net earnings.

In the six months ended June 30, 2008, accumulated other comprehensive income decreased by \$8.1 million which was primarily due to the foreign exchange translation.

Based upon the exchange rate at June 30, 2008, the U.S. dollar has decreased by approximately 14% in value against the Euro since June 30, 2007. See "Quantitative and Qualitative Disclosures about Market Risk."

**Celgar Collective Agreement**

The five-year collective agreement with the union hourly workers at our Celgar mill expired on April 30, 2008. The union representing hourly pulp workers and another pulp producer are currently working to negotiate what the union wishes to utilize as a pattern agreement. Although we consider our relationship with our Celgar hourly employees to be good, we cannot currently provide any assurance that a new collective agreement will be settled without significant work stoppages or disruptions.

**Results of Operations of the Restricted Group Under Our Senior Note Indenture**

The indenture governing our 9.25% senior notes requires that we also provide a discussion in annual and quarterly reports we file with the SEC under Management's Discussion and Analysis of Financial Condition and Results of Operations of the results of operations and financial condition of Mercer Inc. and our restricted subsidiaries under the indenture, referred to as the "Restricted Group." The Restricted Group is comprised of Mercer Inc., certain holding subsidiaries, and our Rosenthal and Celgar mills. The Restricted Group excludes our Stendal mill.

The following is a discussion of the results of operations and financial condition of the Restricted Group. For further information regarding the Restricted Group including, without limitation, a reconciliation to our consolidated results of operations, see Note 8 of our quarterly interim consolidated financial statements included herein.

***Restricted Group Results - Three Months Ended June 30, 2008 Compared to Three Months Ended June 30, 2007***

Revenues for the Restricted Group for the three months ended June 30, 2008 decreased to \$97.7 million from \$104.3 million in the comparative period of 2007, primarily due to the weak U.S. dollar versus the Euro.

List prices for NBSK pulp in Europe were approximately \$576 (\$900) per ADMT in the second quarter of 2008 and approximately \$579 (\$783) in the same period of 2007. Increases in U.S. dollar list prices were more than offset by the weakening of the U.S. dollar versus the Euro.

Pulp sales volume increased to 201,604 ADMTs in the second quarter of 2008 from 196,970 ADMTs in the comparative period of 2007.

Average pulp sales realizations for the Restricted Group were \$484 per ADMT in the three months ended June 30, 2008, compared to \$528 per ADMT in the comparative period of 2007, as a result of the continued weak U.S. dollar.

Pulp production for the Restricted Group increased to 198,892 ADMTs in the second quarter of 2008 from 188,766 ADMTs in the same period of 2007 as our Celgar and Rosenthal mills performed generally well. In the second quarter of 2008, we had a total of 11 days scheduled maintenance downtime at our Celgar mill, compared to 12 days in the same period last year.

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Operating costs and selling, general, administrative and other expenses for the Restricted Group in the second quarter of 2008 increased to 99.6 million from 98.5 million in the comparative period of 2007, as we incurred higher freight costs and warehousing expenses in connection with the shipment backlog at the Port of Vancouver.

On average, fiber costs of the Restricted Group decreased by approximately 2.3% in the second quarter of 2008 versus the same period of 2007.

Fiber costs for our Rosenthal mill declined in the second quarter of 2008 from the comparative period of 2007 and are expected to remain stable in the short term because of lower demand from the European board industry.

At our Celgar mill fiber costs in the second quarter of 2008 were comparable to the same period of 2007 and the prior quarter. Fiber costs have remained consistent despite significant curtailments in sawmilling activity as a result of the faltering North American housing and lumber markets which have sharply decreased the availability of fiber. Recent fiber initiatives at our Celgar mill have helped stabilize fiber supply to the mill and we believe will provide some pricing relief over the balance of the year.

The Restricted Group recorded no contribution to income from the sale of emission allowances by our Rosenthal mill for the three months ended June 30, 2008 as the applicable emissions certificates were not issued until after June 30. In the same quarter last year, the Restricted Group recorded only a negligible contribution to income as a result of weak markets and prices for the sale of emission allowances. In the current period, sales of surplus energy were approximately 26% higher than in the same quarter of 2007.

Operating depreciation and amortization for the Restricted Group decreased slightly to 6.8 million in the current quarter from 7.0 million in the same period of 2007.

In the second quarter of 2008, the Restricted Group reported an operating loss of 1.9 million compared to operating income of 5.8 million in the second quarter of 2007, primarily due to the weak U.S. dollar.

Interest expense for the Restricted Group in the second quarter of 2008 decreased to 4.4 million from 7.0 million in the same quarter last year.

In the second quarter of 2008, the Restricted Group recorded a loss on foreign currency denominated debt of 0.2 million, compared to a gain of 1.0 million in the comparative quarter of 2007.

The Restricted Group reported a net loss from continuing operations for the second quarter of 2008 of 8.2 million. In the second quarter of 2007, the Restricted Group had a net loss from continuing operations of 0.6 million.

Operating EBITDA for the Restricted Group was 5.0 million in the second quarter of 2008 compared to 12.8 million in the comparative quarter of 2007.

Operating EBITDA is defined as operating income (loss) from continuing operations plus depreciation and amortization and non-recurring capital asset impairment charges. Operating

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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, 2008 for additional information relating to such limitations and Operating EBITDA.

The following table provides a reconciliation of net income from continuing operations to Operating EBITDA for the Restricted Group for the periods indicated:

|  | <b>Three Months Ended<br/>June 30,</b> |             |
|--|--|-------------|
|  | <b>2008</b>                            | <b>2007</b> |
|  | <b>(in thousands)</b>                  |             |
| <b>Restricted Group</b>                            |  |             |
| Net loss from continuing operations <sup>(1)</sup> | (8,247)                                | (627)       |
| Income taxes                                       | 1,303                                  | 1,612       |
| Interest expense                                   | 4,440                                  | 6,961       |
| Investment income (expense)                        | 373                                    | (1,136)     |
| Unrealized foreign exchange gain (loss) on debt    | 248                                    | (1,009)     |
| Operating income (loss) from continuing operations | (1,883)                                | 5,801       |
| Add: Depreciation and amortization                 | 6,844                                  | 7,040       |
| Operating EBITDA <sup>(1)</sup>                    | 4,961                                  | 12,841      |

(1) See Note 8 of the interim consolidated financial statements included elsewhere herein for a reconciliation to our consolidated results.

***Restricted Group Results Six Months Ended June 30, 2008 Compared to Six Months Ended June 30, 2007***

Revenues for the Restricted Group for the six months ended June 30, 2008 decreased to 198.8 million from 204.2 million in the comparative period of 2007, primarily as a result of the weak U.S. dollar versus the Euro. List prices for NBSK pulp in Europe were approximately 581 (\$890) per ADMT in the first half of 2008 and approximately 570 (\$770) in the first half of 2007. Increases in U.S. dollar list prices were largely offset by the weakness of the U.S. dollar.

Pulp sales volume increased to 400,275 ADMTs in the first half of 2008 from 388,226 ADMTs in the comparative period of 2007.

Average pulp sales realizations for the Restricted Group were 496 per ADMT in the six months ended June 30, 2008, compared to 525 per ADMT in the comparative period of 2007, due to the weak U.S. dollar.

Pulp production for the Restricted Group increased to 404,710 ADMTs in the first half of 2008 from 390,759 ADMTs in the same period of 2007 as our Celgar and Rosenthal mills performed generally well. We had a total of 12 days scheduled maintenance downtime at our Celgar mill in each of the six months ended June 30, 2008 and 2007.

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Operating costs and selling, general, administrative and other expenses for the Restricted Group in the first half of 2008 increased to 188.4 million from 186.1 million in the comparative period of 2007, as we incurred higher freight costs and warehousing expenses in connection with the shipment backlog at the Port of Vancouver.

On average, fiber costs of the Restricted Group decreased by approximately 5.4% in the first half of 2008 versus the same period of 2007. Fiber costs for our Rosenthal mill declined in the first half of 2008 from the comparative period of 2007 and are expected to remain stable in the short term because of lower demand from the European board industry. However, there is some uncertainty about Russian government tariffs which are expected to reduce Russian wood exports to Europe and which may begin to exert upward pressure on pricing if Scandinavian producers, who traditionally import significant amounts of Russian wood, seek out alternative supply markets such as Germany.

At our Celgar mill fiber costs were lower in the first half of 2008 compared to the same period of 2007 despite significant curtailments in sawmilling activity as a result of the faltering North American housing and lumber markets which have sharply decreased the availability of fiber. Recent fiber initiatives at our Celgar mill, such as new pulp log procurement arrangements and the addition of a second shift in the woodroom, have helped stabilize fiber supply to the mill and we believe will provide some pricing relief over the balance of the year.

The Restricted Group recorded no contribution to income from the sale of emission allowances by our Rosenthal mill for the six months ended June 30, 2008 as the applicable emissions certificates were not issued until after June 30. In the first half of 2007, the Restricted Group recorded only a negligible contribution to income as a result of weak markets and prices for the sale of emission allowances. In the current period, sales of surplus energy were approximately 22% higher than in the same period of 2007.

Operating depreciation and amortization for the Restricted Group increased to 14.2 million in the current period from 13.7 million in the comparative period of 2007.

In the first half of 2008, the Restricted Group's operating income decreased to 10.4 million from 18.4 million in the first six months of 2007, as the generally positive performance of our Rosenthal and Celgar mills was more than offset by the continued weakness in the U.S. dollar against the Euro.

Interest expense for the Restricted Group in the first half of 2008 decreased to 11.2 million from 14.4 million in the same period last year primarily as a result of a lower level of borrowing.

In the first half of 2008, the Restricted Group recorded a gain of 6.4 million on our foreign currency denominated debt, compared to a gain of 2.3 million in the comparative period of 2007.

The Restricted Group reported net income from continuing operations for the first half of 2008 of 3.5 million. In the first half of 2007, net income from continuing operations for the Restricted Group was 4.3 million.

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Operating EBITDA for the Restricted Group was 24.7 million in the first half of 2008 compared to 32.2 million in the comparative period of 2007.

Operating EBITDA is defined as operating income (loss) from continuing operations 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, 2008 for additional information relating to such limitations and Operating EBITDA.

The following table provides a reconciliation of net income from continuing operations to Operating EBITDA for the Restricted Group for the periods indicated:

|  | <b>Six Months Ended<br/>June 30,<br/>2008                  2007<br/>(in thousands)</b> |         |
|--|--|---------|
| <b>Restricted Group</b>                              |  |         |
| Net income from continuing operations <sup>(1)</sup> | 3,531  | 4,530   |
| Income taxes   | 3,457  | 4,150   |
| Interest expense                                     | 11,152   | 14,418  |
| Investment income                                    | (1,363)  | (2,440) |
| Unrealized foreign exchange gain on debt             | (6,379)  | (2,263) |
| <br>   |  |         |
| Operating income from continuing operations          | 10,398   | 18,395  |
| Add: Depreciation and amortization                   | 14,336   | 13,789  |
| <br>   |  |         |
| Operating EBITDA <sup>(1)</sup>                      | 24,734   | 32,184  |

(1) See Note 8 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 for the periods indicated:

|  | <b>As at<br/>June 30,<br/>2008</b> | <b>As at<br/>December<br/>31,<br/>2007</b> |
|--|------------------------------------|--|
|  | <b>(in thousands)</b>              |  |
| <b>Restricted Group Financial Position<sup>(1)</sup></b> |                                    |  |
| Cash and cash equivalents                                | 70,151                             | 59,371                                     |
| Working capital  | 137,389                            | 120,486                                    |

|                               |         |         |
|-------------------------------|---------|---------|
| Property, plant and equipment | 358,250 | 385,569 |
| Total assets                  | 617,934 | 627,854 |
| Long-term liabilities         | 292,263 | 305,158 |
| Shareholders' equity          | 275,311 | 278,582 |

(1) See Note 8 of the interim consolidated financial statements included elsewhere herein for a reconciliation to our consolidated results.

At June 30, 2008, the Restricted Group had cash and cash equivalents of 70.2 million, compared to 59.4 million at December 31, 2007. At June 30, 2008, the Restricted Group had working capital of 137.4 million.

As at June 30, 2008, we had not drawn any amount under the Rosenthal revolving term credit facility and had drawn approximately 21.8 million under the C\$40.0 million Celgar revolving credit facility.

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We expect the Restricted Group to meet its interest and debt service obligations and meet the working and maintenance capital requirements for its operations with cash flow from operations, cash on hand and the revolving working capital loan facilities for the Rosenthal and Celgar mills.

**Critical Accounting Policies**

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

For information about both our significant and critical accounting policies, see our annual report on Form 10-K for the fiscal year ended December 31, 2007.

**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. These statements appear in a number of different places in this report and can be identified by words such as estimates, projects, expects, intends, believes, plans, or their negatives or other comparable words. Also look for discussions of strategy that involve risks and uncertainties. Forward-looking statements include statements regarding the outlook for our future operations, forecasts of future costs and expenditures, the evaluation of market conditions, the outcome of legal proceedings, the adequacy of reserves, or other business plans. You are cautioned that any such forward-looking statements are not guarantees and may involve risks and uncertainties. Our actual results may differ materially from those in the forward-looking statements due to risks facing us or due to actual facts differing from the assumptions underlying our estimates. Some of these risks and assumptions include those set forth in reports and other documents we have filed with or furnished to the SEC, including in our annual report on Form 10-K for the fiscal year ended December 31, 2007. 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.

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**Cyclical Nature of Business**

*Revenues*

The pulp business is cyclical in nature and markets for our principal products are characterized by periods of supply and demand imbalance, which in turn affects product prices. 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 earnings. 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. Although pulp prices have improved commencing in the latter part of 2005 and through the first half of 2008, we cannot predict the impact of future economic weakness in certain world markets or the impact of war, terrorist activity or other events on our markets.

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 price for 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 manufacturing facilities. 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 raw materials increase, or both, demand for our products may decline and our sales and profitability could be materially adversely affected.

*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. 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.

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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 U.S. dollar and the Euro and to a lesser extent the Canadian dollar, which may affect our results of operations and financial condition and, consequently, our fair value. We 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 currency risks. We may in the future use derivatives to reduce or limit our exposure to fluctuations in pulp prices. We also use derivatives to reduce our potential losses or to augment our potential gains, depending on our management's perception of future economic events and developments. These types of derivatives are generally highly speculative in nature. They are also very volatile as they are highly leveraged given that margin requirements are relatively low in proportion to notional amounts.

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

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

During the first six months of 2008, we recorded an unrealized gain of \$12.7 million loss before minority interests on our outstanding interest rate derivatives compared to realized and unrealized gains of \$24.7 million in the comparative period of 2007.

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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. Based on such evaluation, our Principal Executive Officer and Principal Financial Officer have concluded that, as of the end of such period, our disclosure controls and procedures are effective to ensure that information required to be disclosed in the reports that are filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms and to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to management, including its Principal Executive Officer and Principal Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. It should be noted that any system of controls is based in part upon certain assumptions designed to obtain reasonable (and not absolute) assurance as to its effectiveness, and there can be no assurance that any design will succeed in achieving its stated goals.

*Changes in Internal Controls.* There have been no significant changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**Table of Contents****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, 2007. 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**

The new energy project we have commenced at our Celgar mill to increase its production of green energy and optimize its power generation capacity is subject to customary risks and uncertainties inherent for large capital projects which could result in the energy project not completing on schedule or as budgeted. Delays to Celgar receiving any operating permits or any required amendments to such permits could result in construction delays, operational deficiencies or funding shortfalls. Furthermore, the Celgar mill could experience operating difficulties or delays during the start-up period when production of green energy is being ramped up. The Celgar mill may not achieve our planned power generation or cost projections.

There can be no assurance that the amendments to Germany's Renewable Energy Resources Act scheduled to take effect January 1, 2009 will be implemented in their current form. Additional and future amendments to the Act could adversely affect the eligibility of our Rosenthal and Stendal mills to participate in this statutory program and/or the tariffs paid thereunder. As a result we cannot predict with any certainty the amount of future sales of surplus energy we may be able to generate or benefits we may realize, if any, pursuant to this Act.

Other than inherent risks associated with the matters listed above, 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, 2007.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITYHOLDERS**

We held our annual meeting of shareholders on June 5, 2008. Matters voted upon and votes cast at the meeting were as follows:

## 1. Election of Directors

|                      | For        | Withheld | Abstentions and Broker Non-Votes |
|----------------------|------------|----------|----------------------------------|
| Jimmy S.H. Lee       | 25,154,655 | 95,552   |                                  |
| Kenneth A. Shields   | 25,152,529 | 97,678   |                                  |
| William D. McCartney | 25,152,529 | 97,678   |                                  |
| Graeme A. Witts      | 25,154,655 | 95,552   |                                  |
| Eric Lauritzen       | 25,154,655 | 95,552   |                                  |
| Guy W. Adams         | 25,154,655 | 95,552   |                                  |
| George Malpass       | 25,154,655 | 95,552   |                                  |

## 2. Appointment of our independent auditors

|   | For        | Against | Abstentions and Broker Non-Votes |
|---|------------|---------|----------------------------------|
| Ratification of appointment of PricewaterhouseCoopers LLP | 24,483,337 | 759,834 | 7,036                            |

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**ITEM 6. EXHIBITS**

**Exhibit**

| <b>No.</b> | <b>Description</b>                                   |
|------------|--|
| 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: July 31, 2008  
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