PENN NATIONAL GAMING INC
Form 10-Q
August 09, 2006

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2006

OR

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

For the transition period from to

Commission file number: 0-24206

PENN NATIONAL GAMING, INC.

(Exact name of registrant as specified in its charter)

Pennsylvania	**23-2234473**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

825 Berkshire Blvd., Suite 200
Wyomissing, PA 19610
(Address of principal executive offices)

610-373-2400
(Registrant s telephone number including area code)

Not Applicable
(Former name, former address, and former fiscal year, if changed since last report)

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 x No o

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

Large accelerated filer x Accelerated filer o Non-accelerated filer o

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

Indicate the number of shares outstanding of each of the registrant s classes of common stock, as of the latest practicable date.

Title	Outstanding as of August 3, 2006
Common Stock, par value $.01 per share	86,518,164 (includes 440,000 shares of restricted stock)

This report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Actual results may vary materially from expectations. Although Penn National Gaming, Inc. and its subsidiaries (collectively, the Company) believe that their expectations are based on reasonable assumptions within the bounds of their knowledge of its business and operations, there can be no assurance that actual results will not differ materially from the Company s expectations. Meaningful factors which could cause actual results to differ from expectations include, but are not limited to, risks related to the following: the ability of the Company to recover under its insurance policies for Hurricane Katrina damage; the passage of state, federal or local legislation that would expand, restrict, further tax or prevent gaming operations in the jurisdictions in which we do business; the activities of our competitors; increases in the effective rate of taxation at any of our properties or at the corporate level; successful completion of capital projects at our gaming and pari-mutuel facilities; our ability to integrate and recognize the benefits of integrating Argosy Gaming Company; the existence of attractive acquisition candidates, the costs and risks involved in the pursuit of those acquisitions and our ability to integrate those acquisitions; our ability to maintain regulatory approvals for our existing businesses and to receive regulatory approvals for our new businesses (including, without limitation, the issuance of a final operator s license in Pennsylvania); the maintenance of agreements with our horsemen, pari-mutuel clerks and other organized labor groups; our dependence on key personnel; the impact of terrorism and other international hostilities; the availability and cost of financing; and other factors as discussed in the Company s Annual Report on Form 10-K for the year ended December 31, 2005 filed with the United States Securities and Exchange Commission. The Company does not intend to update publicly any forward-looking statements except as required by law.

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PENN NATIONAL GAMING, INC. AND SUBSIDIARIES

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Penn National Gaming, Inc. and Subsidiaries
Consolidated Balance Sheets
(in thousands, except share and per share data)

	June 30, 2006 *(unaudited)*	**December 31, 2005**
Assets		
Current assets		
Cash and cash equivalents	$ 130,318	$ 132,620
Receivables, net of allowance for doubtful accounts of $3,001 and $2,994 at June 30, 2006 and December 31, 2005, respectively	53,305	47,632
Insurance receivable	20,079	51,160
Prepaid expenses and other current assets	47,312	26,780
Deferred income taxes	32,153	48,150
Total current assets	283,167	306,342
Property and equipment, net	1,194,664	1,059,892
Other assets		
Investment in and advances to unconsolidated affiliate	18,018	17,184
Goodwill	1,832,986	1,848,661
Other intangible assets	740,385	743,521
Deferred financing costs, net of accumulated amortization of $10,818 and $7,349 at June 30, 2006 and December 31, 2005, respectively	63,001	70,960
Other assets	90,656	92,861
Restricted assets held for sale	50,972	50,983
Total other assets	2,796,018	2,824,170
Total assets	$ 4,273,849	$ 4,190,404
Current liabilities		
Current maturities of long-term debt	18,447	18,567
Accounts payable	20,163	25,549
Accrued expenses	89,221	116,552
Accrued interest	30,254	33,303
Accrued salaries and wages	51,800	54,579
Gaming, pari-mutuel, property, and other taxes	41,307	47,724
Income taxes payable	4,542	18,284
Other current liabilities	23,143	26,751
Total current liabilities	278,877	341,309
Long-term liabilities		
Long-term debt, net of current maturities	2,788,958	2,767,662
Deferred income taxes	254,667	259,708
Liabilities held for sale	275,042	275,182
Total long-term liabilities	3,318,667	3,302,552
Shareholders' equity		
Preferred stock ($.01 par value, 1,000,000 shares authorized, none issued and outstanding at June 30, 2006 and December 31, 2005)		
Common stock ($.01 par value, 200,000,000 shares authorized, 86,495,724 shares at June 30, 2006, and 85,064,886 shares at December 31, 2005, issued)	865	850
Treasury stock (1,698,800 shares issued and outstanding at June 30, 2006 and December 31, 2005)	(2,379)	(2,379)
Additional paid-in capital	235,964	206,763

Retained earnings	425,147	340,469
Accumulated other comprehensive income	16,708	840
Total shareholders' equity	676,305	546,543
Total liabilities and shareholders' equity	$ 4,273,849	$ 4,190,404

See accompanying notes to consolidated financial statements.

Penn National Gaming, Inc. and Subsidiaries
Consolidated Statements of Income
(in thousands, except per share data)
(unaudited)

	For the Three Months Ended June 30, 2006	2005	For the Six Months Ended June 30, 2006	2005
Revenues				
Gaming	$ 490,804	$ 254,961	$ 994,254	$ 500,137
Racing	13,635	13,306	27,202	25,105
Management service fee	4,921	4,700	9,308	8,767
Food, beverage and other	52,417	39,877	104,985	77,150
Gross revenues	561,777	312,844	1,135,749	611,159
Less promotional allowances	(24,004)	(16,640)	(50,174)	(33,525)
Net revenues	537,773	296,204	1,085,575	577,634
Operating expenses				
Gaming	254,882	136,288	510,626	267,021
Racing	10,855	10,259	20,926	19,069
Food, beverage and other	48,871	25,869	97,228	49,725
General and administrative	73,600	46,001	148,611	92,239
Depreciation and amortization	27,728	15,969	57,446	31,464
Settlement costs		28,175		28,175
Total operating expenses	415,936	262,561	834,837	487,693
Income from continuing operations	121,837	33,643	250,738	89,941
Other income (expenses)				
Interest expense	(47,766)	(12,324)	(96,195)	(28,828)
Interest income	867	930	1,770	2,222
Earnings from joint venture	574	642	987	985
Other	184	(74)	74	(94)
Loss on early extinguishment of debt		(869)	(10,022)	(16,673)
Total other expenses	(46,141)	(11,695)	(103,386)	(42,388)
Income from continuing operations before income taxes	75,696	21,948	147,352	47,553
Taxes on income	33,001	7,055	62,674	16,407
Net income from continuing operations	42,695	14,893	84,678	31,146
Loss from discontinued operations, net of tax		(2,774)		(3,221)
Net income	$ 42,695	$ 12,119	$ 84,678	$ 27,925
Earnings (loss) per share-Basic				
Income from continuing operations	$ 0.51	$ 0.18	$ 1.01	$ 0.38
Discontinued operations, net of tax		(0.03)		(0.04)
Basic earnings per share	$ 0.51	$ 0.15	$ 1.01	$ 0.34
Earnings (loss) per share-Diluted				
Income from continuing operations	$ 0.49	$ 0.17	$ 0.98	$ 0.36
Discontinued operations, net of tax		(0.03)		(0.03)
Diluted earnings per share	$ 0.49	$ 0.14	$ 0.98	$ 0.33

See accompanying notes to consolidated financial statements.

Penn National Gaming, Inc. and Subsidiaries
Consolidated Statements of Changes in Shareholders Equity
(in thousands, except share data) (unaudited)

	Common Stock Shares	Amount	Treasury Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Total Shareholders Equity	Comprehensive Income
Balance, December 31, 2005	85,064,886	$ 850	$ (2,379)	$ 206,763	$ 340,469	$ 840	$ 546,543	
Exercise of stock options including tax benefit of $9,259	990,838	11		28,094			28,105	
Restricted stock activity	440,000	4		1,107			1,111	
Change in fair value of interest rate swap contracts, net of income taxes of $9,075						15,788	15,788	15,788
Foreign currency translation adjustment						80	80	80
Net income					84,678		84,678	84,678
Balance, June 30, 2006	86,495,724	$ 865	$ (2,379)	$ 235,964	$ 425,147	$ 16,708	$ 676,305	$ 100,546
Balance, December 31, 2004	83,131,940	$ 831	$ (2,379)	$ 178,459	$ 219,539	$ 1,642	$ 398,092	
Exercise of stock options including tax benefit of $16,314	1,793,946	18		26,298			26,316	
Restricted stock activity				239			239	
Change in fair value of interest rate swap contracts, net of income taxes of $563						(1,046)	(1,046)	(1,046)
Amortization of unrealized loss on interest rate swap contracts, net of income taxes of $29						(54)	(54)	
Foreign currency translation adjustment						(65)	(65)	(65)
Net income					27,925		27,925	27,925
Balance, June 30, 2005	84,925,886	$ 849	$ (2,379)	$ 204,996	$ 247,464	$ 477	$ 451,407	$ 26,814

See accompanying notes to consolidated financial statements.

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Penn National Gaming, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(in thousands) (unaudited)

	Six Months Ended June 30, 2006	2005 Revised - see Note 2
Operating activities		
Net income	$ 84,678	$ 27,925
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	57,446	31,464
Amortization of deferred financing costs charged to interest expense	5,740	1,650
Amortization of the unrealized gain on interest rate swap contracts charged to interest expense, net of income tax benefit		(54)
Loss on sale of fixed assets	374	222
Earnings from joint venture	(987)	(985)
Loss relating to early extinguishment of debt	2,255	7,246
Deferred income taxes	(1,811)	(110,757)
Charge for stock compensation	10,404	239
Tax benefit from stock options exercised		16,314
(Increase) decrease net of businesses acquired		
Accounts receivable	(5,673)	(4,803)
Insurance receivable	(21,116)	
Prepaid expenses and other current assets	4,331	(5,150)
Prepaid income taxes		5,707
Other assets	1,079	(9,814)
(Decrease) increase, net of businesses acquired		
Accounts payable	(5,386)	(1,253)
Accrued expenses	(26,552)	27,997
Accrued interest	(3,049)	(3,262)
Accrued salaries and wages	(2,779)	(2,277)
Gaming, pari-mutuel, property and other taxes	(6,417)	1,553
Income taxes payable	(13,992)	98,424
Other current liabilities	(3,608)	(7,180)
Operating cash flows from discontinued operations	(129)	(10,130)
Net cash provided by operating activities	74,808	63,076
Investing activities		
Expenditures for property and equipment	(118,055)	(51,693)
Proceeds from sale of property and equipment	840	197
Proceeds from sale of business		274,523
Acquisition of businesses, net of cash acquired		(350)
Distributions from (payments to) joint venture	153	(20)
Investing cash flows from discontinued operations		(1,131)
Net cash (used in) provided by investing activities	(117,062)	221,526
Financing activities		
Proceeds from exercise of options	9,553	10,001
Proceeds from issuance of long-term debt	205,028	250,000
Principal payments on long-term debt	(183,852)	(470,527)
Increase in deferred financing cost	(36)	(6,393)
Tax benefit from stock options exercised	9,259	
Net cash provided by (used in) financing activities	39,952	(216,919)
Net (decrease) increase in cash and cash equivalents	(2,302)	67,683
Cash and cash equivalents at beginning of period	132,620	87,620
Cash and cash equivalents at end of period	$ 130,318	$ 155,303

Supplemental disclosure

Interest expense paid	$	97,488	$	30,368
Income taxes paid	$	68,500	$	21,275

See accompanying notes to consolidated financial statements.

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Penn National Gaming, Inc. and Subsidiaries

Notes to the Consolidated Financial Statements

1. Basis of Presentation

The accompanying unaudited consolidated financial statements of Penn National Gaming, Inc. (Penn) and subsidiaries (collectively, the Company) have been prepared in accordance with United States (U.S.) generally accepted accounting principles (GAAP) for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The notes to the consolidated financial statements contained in the Annual Report on Form 10-K for the year ended December 31, 2005 should be read in conjunction with these consolidated financial statements. For purposes of comparability, certain prior year amounts have been reclassified to conform to the current year presentation. Operating results for the six months ended June 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

2. Summary of Significant Accounting Policies

Revenue Recognition and Promotional Allowances

Gaming revenue is the aggregate net difference between gaming wins and losses, with liabilities recognized for funds deposited by customers before gaming play occurs and for chips in the customers possession.

Racing revenue includes the Company s share of pari-mutuel wagering on live races after payment of amounts returned as winning wagers, and the Company s share of wagering from import and export simulcasting, as well as its share of wagering from its off-track wagering facilities (OTWs).

Revenue from the management service contract for Casino Rama is based upon contracted terms and is recognized when services are performed.

Food, beverage and other revenue is recognized as services are performed.

Revenues are recognized net of certain sales incentives in accordance with the Emerging Issues Task Force (EITF) consensus on Issue 01-9, Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s products) (EITF 01-9). The consensus in EITF 01-9 requires that sales incentives and points earned in point-loyalty programs be recorded as a reduction of revenue. The Company recognizes incentives related to gaming play and points earned in point-loyalty programs as a direct reduction of gaming revenue.

During the second quarter of 2006, as a result of the Company s review of trends in interpreting accounting pronouncements and gaming industry practices for accounting for customer cash incentives, the Company reclassified cash redemption coupons to contra-revenue from operating expense. The reclassification represented approximately 3% of the Company s revenues for the three and six months ended June 30, 2005, and had no effect on operating income, net income or earnings per share for the three and six months ended June 30, 2005.

The retail value of accommodations, food and beverage, and other services furnished to guests without charge is included in gross revenues and then deducted as promotional allowances. The estimated cost of providing such promotional allowances is primarily included in gaming expenses. The amounts included in promotional allowances for the three and six months ended June 30, 2006 and 2005 are as follows:

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2006	**2005**	**2006**	**2005**
	(in thousands)		**(in thousands)**	
Rooms	$ 2,804	$ 1,788	$ 5,580	$ 3,592
Food and beverage	19,537	11,995	39,236	24,197
Other	1,663	2,857	5,358	5,736
Total promotional allowances	$ 24,004	$ 16,640	$ 50,174	$ 33,525

The estimated cost of providing such complimentary services for the three and six months ended June 30, 2006 and 2005 that is included in operating expenses was as follows:

	Three Months Ended June 30, 2006 (in thousands)	2005	Six Months Ended June 30, 2006 (in thousands)	2005
Rooms	$ 1,174	$ 1,044	$ 2,315	$ 2,139
Food and beverage	13,644	8,099	27,585	16,240
Other	817	812	3,613	1,605
Total cost of complimentary services	$ 15,635	$ 9,955	$ 33,513	$ 19,984

Earnings Per Share

Basic earnings per share (EPS) is computed by dividing net income applicable to common stock by the weighted-average common shares outstanding during the period. Diluted EPS reflects the additional dilution for all potentially-dilutive securities, such as stock options.

The following table reconciles the weighted-average common shares outstanding used in the calculation of basic earnings per share to the weighted-average common shares outstanding used in the calculation of diluted earnings per share. Options to purchase 1,645,812 and 1,827,280 shares of common stock were outstanding for the three and six months ended June 30, 2006, respectively, but were not included in the computation of diluted earnings per share because they are antidilutive. Options to purchase 25,000 and 30,000 shares of common stock were outstanding for the three and six months ended June 30, 2005, respectively, but were not included in the computation of diluted earnings per share because they are antidilutive.

	Three Months Ended June 30, 2006 (in thousands)	2005	Six Months Ended June 30, 2006 (in thousands)	2005
Determination of shares:				
Weighted-average common shares outstanding	84,333	83,227	83,991	82,497
Assumed conversion of dilutive stock options	2,396	2,505	2,444	3,066
Diluted weighted-average common shares outstanding	86,729	85,732	86,435	85,563

Stock-Based Compensation

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment (SFAS 123(R)), which requires the Company to expense the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. This expense must be recognized ratably over the requisite service period following the date of grant.

The Company elected the modified prospective application method for adoption, which results in the recognition of compensation expense using the provisions of SFAS 123(R) for all share-based awards granted or modified after December 31, 2005, and the recognition of compensation expense using the original provisions of SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123), as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure (SFAS 148), with the exception of the method of recognizing forfeitures, for all unvested awards outstanding at the date of adoption. Under this transition method, the results of operations of prior periods have not been restated. Accordingly, the Company will continue to provide pro forma financial information for prior periods to illustrate the effect on net income and earnings per share of applying the fair value recognition provisions of SFAS 123, as amended by SFAS 148.

Prior to January 1, 2006, the Company accounted for stock-based compensation using the intrinsic-value method in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), as interpreted by Financial Accounting Standards Board (FASB) Interpretation No. 44, Accounting for Certain

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Transactions Involving Stock Compensation. Under the intrinsic-value method, because the exercise price of the Company s employee stock options was equal to the market price of the underlying stock on the date of grant, no compensation expense was recognized. However, there were situations that could have occurred, such as the accelerated vesting of options or the issuance of restricted stock, that required a current charge to income.

The most significant difference between the fair value approaches prescribed by SFAS 123 and SFAS 123(R) and the intrinsic-value method prescribed by APB 25 related to the recognition of compensation expense for stock option awards based on their grant-date fair value. Under SFAS 123, the Company estimated the fair value of stock option grants using the Black-Scholes option-pricing model. The following table reflects the pro forma impact on net income and earnings per share for the three and six months ended June 30, 2005 of accounting for the Company s stock-based compensation using the fair value provisions of SFAS 123, as amended by SFAS 148. The effects of applying SFAS 123 and SFAS 148 in the pro forma disclosure below are not indicative of future amounts. Additional awards in future years are anticipated.

	Three Months Ended June 30, 2005 (in thousands)		**Six Months Ended June 30, 2005**	
Net income, as reported	$	12,119	$	27,925
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	81		157	
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects	(2,674	)	(5,065	)
Pro forma net income	$	9,526	$	23,017
Earnings per share:				
Basic-as reported	$	0.15	$	0.34
Basic-*pro forma*	0.11		0.28	
Diluted-as reported	0.14		0.33	
Diluted-*pro forma*	0.11		0.27	

Prior to the adoption of SFAS 123(R), the Company included all tax benefits associated with stock-based compensation as operating cash flows in the consolidated statements of cash flows. SFAS 123(R) requires any reduction in taxes payable resulting from tax deductions that exceed the recognized compensation expense (excess tax benefits) to be classified as financing cash flows. The Company included $9.3 million of excess tax benefits in the Company s cash flows from financing activities for the six months ended June 30, 2006 that would have been classified as operating cash flows had the Company not adopted SFAS 123(R).

The fair value for stock options was estimated at the date of grant using the Black-Scholes option-pricing model, which requires management to make certain assumptions. The risk-free interest rate was based on the U.S. Treasury spot rate with a remaining term equal to the expected life assumed at the date of grant. Expected volatility was estimated based on the historical volatility of the Company s stock price over a period of 4.52 years, in order to match the expected life of the options up to the grant date. There is no expected dividend yield since the Company has not paid any cash dividends on its common stock since its initial public offering in May 1994, and since the Company intends to retain all of its earnings to finance the development of its business for the foreseeable future. The weighted-average expected life was based on the contractual term of the stock option and expected employee exercise dates, which was based on the historical exercise behavior of the Company s employees. Forfeitures are estimated at the date of grant based on historical experience. Prior to the adoption of SFAS 123(R), the Company recorded forfeitures as they occurred for purposes of estimating pro forma compensation expense under SFAS 123. The impact of forfeitures is not material. The following are the weighted-average assumptions used in the Black-Scholes option-pricing model for the six months ended June 30, 2006 and 2005:

	Six Months Ended June 30, 2006		2005	
Risk-free interest rate	4.34	%	3.40	%
Expected volatility	46.98	%	40.00	%
Dividend yield				
Weighted-average expected life (years)	4.52		5.29	
Forfeiture rate	2.00	%	2.00	%

Statements of Cash Flows

Beginning with the year ended December 31, 2005, the Company changed the presentation of its cash flows to separately disclose the operating, investing and financing portions of cash flows attributable to the Company s discontinued operations. The Company had previously reported these amounts on a combined basis. This change was in response to public statements by the Securities and Exchange Commission Staff concerning the classification of discontinued operations within the statements of cash flows. For the six months ended June 30, 2006 and 2005, cash flows relating to discontinued operations have been separately disclosed within operating and investing activities. For the six months ended June 30, 2006 and 2005, there were no cash flows relating to discontinued operations that were financing activities.

Certain Risks and Uncertainties

The Company s operations are dependent on its continued licensing by state gaming commissions. The loss of a license, in any jurisdiction in which the Company operates, could have a material adverse effect on future results of operations.

The Company is dependent on each gaming property s local market for a significant number of its patrons and revenues. If economic conditions in these areas deteriorate or additional gaming licenses are awarded in these markets, the Company s results of operations could be adversely affected.

The Company is also dependent upon a stable gaming and admission tax structure in the states in which it operates. Any change in the tax structure could have a material adverse affect on future results of operations.

3. New Accounting Pronouncement

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), which is an interpretation of SFAS No. 109, Accounting for Income Taxes (SFAS 109).

FIN 48 creates a single model to address uncertainty in tax positions, and clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS 109 by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in an enterprise s financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition, and clearly scopes out income taxes from SFAS No. 5, Accounting for Contingencies.

FIN 48 is effective for fiscal years beginning after December 15, 2006, but earlier application of the provisions of FIN 48 is encouraged if an enterprise has not yet issued financial statements, including interim financial statements, in the period that FIN 48 is adopted. Differences between the amounts recognized in the statements of financial position prior to the adoption of FIN 48 and the amounts reported after adoption should be accounted for as a cumulative-effect adjustment recorded to the beginning balance of retained earnings.

The Company is currently determining the impact of FIN 48 on its consolidated financial statements.

4. Acquisitions

Argosy Gaming Company

On October 3, 2005, the Company acquired 100% of the stock of Argosy Gaming Company (Argosy). The acquisition, which was accretive to the Company s results of operations, reflects the continuing efforts of the Company to diversify by reducing its dependency on individual

properties and legislative jurisdictions. The transaction was accounted for as a purchase transaction, in accordance with SFAS No. 141, Business Combinations. As a result, the net assets of Argosy were recorded at their fair value, with the excess of the purchase price over the fair value of the net assets acquired allocated to goodwill.

In order to assist the Company in assigning values of assets acquired and liabilities assumed in this transaction, the Company obtained a third-party valuation of significant identifiable intangible assets acquired, as well as other assets acquired. In addition, the Company recorded an estimate for the deferred tax liability arising from the acquisition due to the difference between the fair value and the tax basis of the net assets acquired. This deferred tax liability estimate increased the estimated amount of goodwill recorded in the acquisition. As the deferred tax liability is an estimate, it is subject to change, as the Company finalizes certain valuations and tax analyses. Changes to this estimate and the current tax liability, if any, will also affect goodwill and will not have a material impact on the Company s consolidated statements of income.

The pro forma consolidated results of operations for the three and six months ended June 30, 2005, as if the acquisition of Argosy had occurred on January 1, 2005, are as follows (in thousands, except per share data):

	Three Months Ended June 30, 2005	**Six Months Ended June 30, 2005**
Pro Forma		
Net revenues	$ 542,234	$ 1,069,421
Income from continuing operations	82,180	185,731
Net income from continuing operations	21,001	45,916
Basic earnings per share	0.25	0.55
Diluted earnings per share	0.24	0.53

Note 5: Acquisitions of the Company s Annual Report on Form 10-K for the year ended December 31, 2005 provides further detail regarding the Argosy acquisition.

5. Hurricane Katrina

As a result of Hurricane Katrina s direct hit on the Mississippi Gulf Coast on August 29, 2005, two of the Company s casinos, Casino Magic Bay St. Louis and Boomtown Biloxi, were significantly damaged, many employees were displaced and operations ceased at the two properties. Following extensive reconstruction, Boomtown Biloxi reopened on June 29, 2006.

The Company has significant levels of insurance in place to cover the losses resulting from Hurricane Katrina including an all risk insurance policy covering named windstorm damage, flood damage, debris removal, preservation of property expense, demolition and increased cost of construction expense, losses resulting from business interruption and extra expenses, as defined in the policy. The comprehensive business interruption and property damage insurance policies have an overall limit of $400 million, and are subject to property damage deductibles for Casino Magic Bay St Louis and Boomtown Biloxi of approximately $6.0 million and $3.5 million, respectively. The business interruption insurance component of this policy is subject to a five-day deductible.

The Company recognized a pre-tax charge of $21.1 million ($13.7 million after-tax) associated with the expenses incurred from Hurricane Katrina during the twelve months ended December 31, 2005. The costs included property insurance and business interruption policy deductible expense, compensation being paid to employees through November 30, 2005 that exceeded the ordinary payroll limits under the business interruption policy, the purchase of replacement flood insurance for coverage during the remaining insurance policy term, contributions to the Penn National Gaming Foundation for the Hurricane Katrina relief project and costs for insurance claim consultants. The charge did not reflect any loss resulting from the damage to the land-based facilities and casino barges at Casino Magic Bay St. Louis and Boomtown Biloxi, as this amount is not yet known. However, the Company believes that insurance proceeds will be sufficient to fund replacement costs.

The $20.1 million and $51.2 million insurance receivables recorded at June 30, 2006 and December 31, 2005, respectively, were limited to the net historical book value of assets believed to be damaged, destroyed or abandoned, fixed business expenses and out-of-pocket costs for certain additional expenses incurred during the period as a direct result of the hurricane. During the three and six months ended June 30, 2006, the Company received $26.9 million and $52.3 million, respectively, from its insurance carriers relating to Hurricane Katrina. Through December 31, 2005, the Company received $27.3 million from its insurance carriers relating to Hurricane Katrina.

6. Property and Equipment

Property and equipment, net, consists of the following (in thousands):

	June 30, 2006	December 31, 2005
Land and improvements	$ 169,766	$ 155,735
Building and improvements	734,414	699,584
Furniture, fixtures, and equipment	338,296	314,741
Transportation equipment	2,080	1,401
Leasehold improvements	14,854	13,175
Construction in progress	194,587	82,971
Total property and equipment	1,453,997	1,267,607
Less accumulated depreciation and amortization	(259,333)	(207,715)
Property and equipment, net	$ 1,194,664	$ 1,059,892

Depreciation and amortization expense, for property and equipment, totaled $26.1 million and $54.2 million for the three and six months ended June 30, 2006, respectively, as compared to $15.3 million and $30.2 million for the three and six months ended June 30, 2005, respectively. Interest capitalized in connection with major construction projects was $3.3 million and $.7 million for the six months ended June 30, 2006 and 2005, respectively.

7. Goodwill and Other Intangible Assets

The Company s goodwill and intangible assets had a gross carrying value of $2.6 billion at June 30, 2006 and December 31, 2005, and accumulated amortization of $16.1 million and $12.8 million at June 30, 2006 and December 31, 2005, respectively. The table below presents the gross carrying value, accumulated amortization, and net book value of each major class of goodwill and intangible asset at June 30, 2006 and December 31, 2005 (in thousands):

	June 30, 2006 Gross Carrying Value	Accumulated Amortization	Net Book Value	December 31, 2005 Gross Carrying Value	Accumulated Amortization	Net Book Value
Goodwill	$ 1,832,986	$	$ 1,832,986	$ 1,848,661	$	$ 1,848,661
Gaming license and trademarks	711,364		711,364	711,174		711,174
Other intangible assets	45,126	16,105	29,021	45,126	12,779	32,347
Total	$ 2,589,476	$ 16,105	$ 2,573,371	$ 2,604,961	$ 12,779	$ 2,592,182

During the six months ended June 30, 2006, goodwill changed by $15.7 million, primarily due to the finalization of certain fixed asset and deferred tax valuations associated with the Argosy acquisition.

The Company s intangible asset amortization expense was $1.7 million and $3.3 million for the three and six months ended June 30, 2006, respectively,

The following table presents expected intangible asset amortization expense based on existing intangible assets at June 30, 2006 (in thousands):

2006 (six months)	$ 3,329
2007	6,655
2008	6,488
2009	5,988
2010	5,119
Thereafter	1,442
Total	$ 29,021

8. Long-term Debt

Long-term debt, net of current maturities, is as follows (in thousands):

	June 30, 2006	December 31, 2005
Senior secured credit facility	$ 2,345,625	$ 2,148,875
$175 million 8 7⁄8% senior subordinated notes		175,000
$200 million 6 7⁄8% senior subordinated notes	200,000	200,000
$250 million 6 3⁄4% senior subordinated notes	250,000	250,000
$200 million 9% senior subordinated notes	10	10
$350 million 7% senior subordinated notes	153	153
Capital leases	11,617	12,191
	2,807,405	2,786,229
Less current maturities of long-term debt	(18,447)	(18,567)
	$ 2,788,958	$ 2,767,662

The following is a schedule of future minimum repayments of long-term debt as of June 30, 2006 (in thousands):

Within one year	$ 18,447
1-3 years	163,388
3-5 years	593,056
Over 5 years	2,032,514
Total minimum payments	$ 2,807,405

At June 30, 2006 and December 31, 2005, the Company was contingently obligated under letters of credit issued pursuant to its senior secured credit facility with face amounts aggregating $73.1 million and $72.5 million, respectively.

Senior Secured Credit Facility

On October 3, 2005, the Company entered into a $2.725 billion senior secured credit facility to fund the Company s acquisition of Argosy, including payment for all of Argosy s outstanding shares, the retirement of certain long-term debt of Argosy and its subsidiaries, the payment of related transaction costs, and to provide additional working capital.

The senior secured credit facility is secured by substantially all of the assets of the Company.

Interest Rate Swap Contracts

The Company has a policy designed to manage interest rate risk associated with its current and anticipated future borrowings. This policy enables the Company to use any combination of interest rate swaps, futures, options, caps and similar instruments. To the extent the Company

employs such financial instruments pursuant to this policy, they are generally accounted for as hedging instruments. In order to qualify for hedge accounting, the underlying hedged item must expose the Company to risks associated with market fluctuations and the financial instrument used must be designated as a hedge and must reduce the Company s exposure to market fluctuations throughout the hedge period. If these criteria are not met, a change in the market value of the financial instrument is recognized as a gain or loss in the period of change. Net settlements pursuant to the

financial instrument are included as interest expense in the period.

In accordance with the terms of its $2.725 billion senior secured credit facility, the Company was required to enter into interest rate swap agreements in an amount equal to 50% of the outstanding term loan balances within 100 days of the closing date of the credit facility. On October 27, 2005, the Company entered into four interest rate swap contracts with terms from three to five years, notional amounts of $224 million, $274 million, $225 million, and $237 million, for a total of $960 million and fixed interest rates ranging from 4.678% to 4.753%. The annual weighted-average interest rate of the four contracts is 4.71%. On May 8, 2006, the Company entered into three interest rate swap contracts with a term of five years, notional amounts of $100 million each, for a total of $300 million and fixed interest rates ranging from 5.263% to 5.266%. The annual weighted-average interest rate of the three contracts is 5.26%. Under these contracts, the Company pays a fixed interest rate against a variable interest rate based on the 90-day LIBOR rate. The 90-day LIBOR rate relating to these contracts as of June 30, 2006 was 5.11% for the $960 million swaps and 5.16% for the $300 million swaps.

Redemption of 8⅞% Senior Subordinated Notes

In February 2006, the Company called for the redemption of its $175 million 8⅞ % senior subordinated notes. The redemption price was $1,044.38 per $1,000 principal amount, plus accrued and unpaid interest and was made on March 15, 2006. The Company funded the redemption of the notes from available cash and borrowings under its revolving credit facility.

6⅞% Senior Subordinated Notes

On December 4, 2003, the Company completed an offering of $200 million of 6⅞% senior subordinated notes that mature on December 1, 2011. Interest on the notes is payable on June 1 and December 1 of each year, beginning June 1, 2004. The Company used the net proceeds from the offering, totaling approximately $196.6 million after deducting underwriting discounts and related expenses, to repay term loan indebtedness under its previous senior secured credit facility.

The Company may redeem all or part of the notes on or after December 1, 2007 at certain specified redemption prices. Prior to December 1, 2006, the Company may redeem up to 35% of the notes from proceeds of certain sales of its equity securities. The notes are also subject to redemption requirements imposed by state and local gaming laws and regulations.

The 6⅞% notes are general unsecured obligations and are guaranteed on a senior subordinated basis by certain of the Company s current and future wholly-owned domestic subsidiaries. The 6⅞% notes rank equally with the Company s future senior subordinated debt and junior to its senior debt, including debt under the Company s senior secured credit facility. In addition, the 6⅞% notes will be effectively junior to any indebtedness of Penn s non-U.S. Unrestricted Subsidiaries.

The 6⅞% notes and guarantees were originally issued in a private placement pursuant to an exemption from the registration requirements of the Securities Act of 1933 (the Securities Act). On August 27, 2004, the Company completed an offer to exchange the notes and guarantees for notes and guarantees registered under the Securities Act having substantially identical terms.

6¾% Senior Subordinated Notes

On March 9, 2005, the Company completed an offering of $250 million of 6¾% senior subordinated notes. Interest on the notes is payable on March 1 and September 1 of each year, beginning September 1, 2005. These notes mature on March 1, 2015. The 6¾% notes are general unsecured obligations and are not guaranteed by the Company s subsidiaries. The 6¾% notes were issued in a private placement pursuant to an exemption from the registration requirements of the Securities Act. The Company used the net proceeds from the offering to redeem its $200 million 11⅛% senior subordinated notes due March 1, 2008 and repay a portion of the term loan indebtedness under the previous senior

secured credit facility.

Covenants

The Company s senior secured credit facility and $200 million 6⅞% and $250 million 6¾% senior subordinated notes require it, among other obligations, to maintain specified financial ratios and to satisfy certain financial tests, including fixed charge coverage, senior leverage and total leverage ratios. In addition, the Company s senior secured credit facility and $200 million 6⅞% and $250 million 6¾% senior subordinated notes restrict, among other things, the Company s ability to incur additional indebtedness, incur guarantee obligations, amend debt instruments, pay dividends, create liens on assets, make investments, make acquisitions, engage in mergers or consolidations, make capital expenditures, or engage in certain transactions with subsidiaries and affiliates and otherwise restricts corporate activities. At June 30, 2006, the Company was in compliance with all required financial covenants.

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9. Commitments and Contingencies

Litigation

The Company is subject to various legal and administrative proceedings relating to personal injuries, employment matters, commercial transactions and other matters arising in the normal course of business. The Company does not believe that the final outcome of these matters will have a material adverse effect on the Company s consolidated financial position or results of operations. In addition, the Company maintains what it believes is adequate insurance coverage to further mitigate the risks of such proceedings. However, such proceedings can be costly, time consuming and unpredictable and, therefore, no assurance can be given that the final outcome of such proceedings may not materially impact the Company s consolidated financial condition or results of operations. Further, no assurance can be given that the amount or scope of existing insurance coverage will be sufficient to cover losses arising from such matters.

The following proceedings could result in costs, settlements, damages, or rulings that materially impact the Company s consolidated financial condition or operating results. In each instance, the Company believes that it has meritorious defenses, claims and/or counter-claims and intends to vigorously defend itself or pursue its claim.

In October 2002, in response to the Company s plans to relocate the river barge underlying the Boomtown Biloxi casino to an adjacent property, the lessor of the property on which the Boomtown Biloxi casino conducts a portion of its dockside operations filed a lawsuit against the Company in the U.S. District Court for the Southern District of Mississippi seeking a declaratory judgment that (i) the Company must use the leased premises for a gaming use or, in the alternative, (ii) after the move, the Company will remain obligated to make the revenue-based rent payments to plaintiff set forth in the lease. The plaintiff filed this suit immediately after the Mississippi Gaming Commission approved the Company s request to relocate the barge. Since such approval, the Mississippi Department of Marine Resources and the U.S. Army Corps of Engineers have also approved the Company s plan to relocate the barge. In March 2004, the trial court ruled in favor of the Company on all counts. The plaintiff appealed the decision to the Fifth Circuit, and on May 3, 2005, the Fifth Circuit ruled that the trial court s decision should be affirmed in part and reversed and remanded in part. In its decision, the Fifth Circuit upheld the tenant s right to relocate but remanded the case to the trial court because there was insufficient evidence in the record to determine whether the casino barge would be relocated to a place which would trigger the increased rent obligation under the lease. The Court has set a scheduling order setting the trial date for February 26, 2007. The Company believes this case should be resolved on dispositive motions, which are due to be filed by October 16, 2006. The parties have also engaged in settlement negotiations, but have not yet reached a settlement of this matter.

In November 2005, Capital Seven, LLC and Shawn A. Scott (Capital Seven), the sellers of Bangor Historic Track (BHT), filed a demand for arbitration with the American Arbitration Association seeking $30 million plus interest and other damages. Capital Seven alleges a breach of contract by the Company based on the Company s payment of a $51 million purchase price for the purchase of BHT instead of an alleged $81 million purchase price the sellers claim is due under the purchase agreement. The parties had agreed that the purchase price of BHT would be determined, in part, by the applicable gaming taxes imposed by Maine on the Company s operations, and currently are disputing the effective tax rate. The dispute is currently in its initial stages. The Company filed a Counter-Statement and Answer on December 15, 2005, and the parties are in the process of choosing arbitrators.

In conjunction with the Company s merger with Argosy, the Company became responsible for litigation initiated over eight years ago related to the Baton Rouge property formerly owned by Argosy. On November 26, 1997, Capitol House filed an amended petition in the Nineteenth Judicial District Court for East Baton Rouge Parish, State of Louisiana, amending its previously filed but unserved suit against Richard Perryman, the person selected by the Louisiana Gaming Division to evaluate and rank the applicants seeking a gaming license for East Baton Rouge Parish, and adding state law claims against Jazz Enterprises, Inc., the former Jazz Enterprises, Inc. Shareholders, Argosy Gaming Company, Argosy of Louisiana, Inc. and Catfish Queen Partnership in Commendam, d/b/a the Belle of Baton Rouge Casino. This suit alleges that these parties violated the Louisiana Unfair Trade Practices Act in connection with obtaining the gaming license that was issued to Jazz Enterprises, Inc./Catfish Queen Partnership in Commendam. The plaintiff, an applicant for a gaming license whose application was denied by the Louisiana Gaming Division, seeks to prove that the gaming license was invalidly issued and seeks to recover lost gaming revenues that the plaintiff contends it could have earned if the gaming license had been properly issued to the plaintiff. In June 2003, the Louisiana trial court dismissed this lawsuit. The trial court s decision was affirmed by the First Circuit Court of Appeals, but subsequently reversed by the Louisiana Supreme Court on March 24, 2005, which remanded the case back to the trial court for further proceedings. The Company plans to file further dispositive motions. The trial is scheduled for late January 2007.

The Company has the right to seek indemnification from two of the former Jazz Enterprises, Inc. shareholders for any liability suffered as a result of such cause of action, however, there can be no assurance that the former Jazz Enterprises, Inc. shareholders will have assets sufficient to satisfy any claim in excess of Argosy s recoupment rights.

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In May 2006, the Illinois Legislature passed into law House Bill 1918, effective May 26, 2006, which singled out four of the nine Illinois casinos, including the Company s Empress Casino Hotel and Hollywood Casino Aurora, for a 3% tax surcharge to subsidize local horse racing interests. The Company began paying this tax surcharge during the three months ended June 30, 2006, and the Company will continue to pay this tax surcharge in upcoming periods. Prior to the passage of this law, questions were raised regarding its constitutionality. On May 30, 2006, Empress Casino Hotel and Hollywood Casino Aurora joined with the two other riverboats affected by the law, Harrah s Joliet and the Grand Victoria Casino in Elgin, and filed suit in the Circuit Court of the Twelfth Judicial District in Will County, Illinois (the Court), asking the Court to declare the law unconstitutional. The State agreed to the entry of an order that establishes a protest fund for all of the tax surcharge payments and enjoins the Treasurer from making any payments out of that fund pending the final outcome of the litigation. Should the casinos prevail with their challenge, the incremental taxes paid under protest would be refunded. The Company anticipates a long process before a resolution to this matter can be reached.

Operating Lease Commitments

The Company is liable under numerous operating leases for airplanes, automobiles, land for the property on which some of its casinos operate, other equipment and buildings, which expire at various dates through 2093. Total rental expense under these agreements was $7.1 million and $13.0 million for the three and six months ended June 30, 2006, respectively.

The leases for land consist of annual base lease rent payments, plus a percentage rent based on a percent of adjusted gaming wins, as described in the respective leases.

The Company has an operating lease with the City of Bangor for a permanent facility which the Company expects to open in the second quarter of 2008, at a budgeted cost of $90.0 million. This permanent facility is subject to a percentage rent equaling 3% of gross slot revenue. The lease is for an initial term of fifteen years with three ten-year renewal options. The initial term begins with the opening of the permanent facility. An agreement with the City of Bangor calls for a two-year rent moratorium for 2006 and 2007.

The future minimum lease commitments relating to the base lease rent portion of noncancelable operating leases at June 30, 2006 are as follows (in thousands):

Within one year	$ 17,234
1-3 Years	32,511
3-5 Years	21,540
Over 5 years	213,944
Total	$ 285,229

Capital Expenditure Commitments

At June 30, 2006, the Company is contractually committed to spend approximately $66.7 million in capital expenditures for projects in progress.

10. Stock-Based Compensation

In April 1994, the Company s Board of Directors and shareholders adopted and approved the 1994 Stock Option Plan (the 1994 Plan). The 1994 Plan permitted the grant of options to purchase up to 12,000,000 shares of Common Stock, subject to antidilution adjustments, at a price per share no less than 100% of the fair market value of the Common Stock on the date an option is granted with respect to incentive stock options only. The price would be no less than 110% of fair market value in the case of an incentive stock option granted to any individual who owns more than 10% of the total combined voting power of all classes of outstanding stock. The 1994 Plan provided for the granting of both incentive stock options intended to qualify under Section 422 of the Internal Revenue Code of 1986, as amended, and nonqualified stock options, which do not so qualify. The 1994 Plan terminated in April 2004.

On April 16, 2003, the Company s Board of Directors adopted and approved the 2003 Long Term Incentive Compensation Plan (the 2003 Plan). On May 22, 2003, the Company s shareholders approved the 2003 Plan. The 2003 Plan was effective June 1, 2003 and permits the grant of options to purchase Common Stock and other market-based and performance-based awards. Up to 12,000,000 shares of Common Stock are available for awards under the 2003 Plan. The 2003 Plan provides for the granting of both incentive stock options intended to qualify under Section 422 of the Internal Revenue Code of 1986, as amended, and nonqualified stock options, which do not so qualify. The exercise price per share may be no less than (i) 100% of the fair market value of the Common Stock on the date an option is granted for incentive stock options and

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(ii) 85% of the fair market value of the Common Stock on the date an option is granted for nonqualified stock options. Unless this plan is extended, no awards shall be granted or exchanges effected under this plan after May 31, 2013. At June 30, 2006, there were 4,490,500 options available for future grants under the 2003 Plan.

Stock options that expire between February 8, 2007 and January 12, 2016 have been granted to officers, directors and employees to purchase Common Stock at prices ranging from $2.03 to $41.37 per share. All options were granted at the fair market value of the Common Stock on the date the options were granted.

The following table contains information on stock options for the six months ended June 30, 2006:

	Number of Option Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2005	7,733,814	$ 17.09		
Granted	1,446,500	33.19		
Exercised	(990,838)	9.64		
Canceled	(52,500)	20.28		
Outstanding at June 30, 2006	8,136,976	$ 20.84	5.32	$ 145,976

Included in the above are common stock options that were issued in 2003 to the Company s Chairman outside of the 1994 Plan and the 2003 Plan. These options were issued at $7.95 per share, and are exercisable through February 6, 2013. At June 30, 2006 and December 31, 2005, the number of these common stock options that were outstanding was 23,750 and 95,000, respectively. In addition, the Company issued 160,000 restricted stock awards in 2004, which fully vest in May 2009, and issued 280,000 restricted stock awards in 2006, which fully vest by 2011. The weighted-average grant-date fair value of options granted during the six months ended June 30, 2006 and 2005 were $14.68 and $12.08, respectively.

The aggregate intrinsic value of stock options exercised during the six months ended June 30, 2006 and 2005 was $28.1 million and $49.3 million, respectively.

At June 30, 2006, there were 2,842,226 shares that were exercisable, with a weighted-average exercise price of $13.43, a weighted-average remaining contractual term of 4.06 years, and an aggregate intrinsic value of $72.0 million.

The following table summarizes information about stock options outstanding at June 30, 2006:

	Exercise Price Range			Total
	$2.03 to $12.15	$14.56 to $29.22	$30.18 to $41.37	$2.03 to $41.37
Outstanding options				
Number outstanding	3,609,176	2,888,800	1,639,000	8,136,976
Weighted-average remaining contractual life (years)	3.94	6.05	7.04	5.32
Weighted-average exercise price	$ 9.57	$ 27.92	$ 33.20	$ 20.84
Exercisable options				
Number outstanding	2,130,676	695,300	16,250	2,842,226
Weighted-average exercise price	$ 8.73	$ 27.42	$ 32.08	$ 13.43

Compensation costs related to stock-based compensation for the six months ended June 30, 2006 totaled $10.4 million, and are included in the consolidated statements of income under general and administrative expenses. The net impact for the six months ended June 30, 2006 to earnings was $6.8 million ($.08 per diluted share).

At June 30, 2006, the total compensation cost related to nonvested awards not yet recognized equaled $55.3 million, including $45.5 million for stock options and $9.8 million for restricted stock. This cost is expected to be recognized over the remaining vesting periods, which will not exceed five years.

11. Segment Information

In accordance with SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information (SFAS 131), the Company views each property as an operating segment. Historically, the Company aggregated its gaming properties that were economically similar, offered similar types of products and services, catered to the same types of customers and were

similarly regulated into a reportable segment called gaming, and aggregated its racing properties that were economically similar, offered similar products and services, catered to the similar types of customers and were similarly regulated into a reportable segment called racing.

Beginning in the first quarter of 2006, the Company modified its segment reporting from two reportable segments to one reportable segment, as the Company believes that its gaming and racing properties can now be aggregated together in accordance with SFAS 131, due to ongoing changes at its racing properties, including the upcoming introduction of slot machines at Penn National Race Course.

Note 15: Segment Information of the Company s Annual Report on Form 10-K for the year ended December 31, 2005, provides further detail regarding the Company s historical segment reporting.

12. Subsidiary Guarantors

Under the terms of the $2.725 billion senior secured credit facility, all of the Company s subsidiaries are guarantors under the agreement, with the exception of several minor subsidiaries with total assets of $12.7 million (less than .3% of total assets at June 30, 2006). Each of the subsidiary guarantors are 100% owned by Penn. In addition, the guarantees provided by the Company s subsidiaries under the terms of the $2.725 billion senior secured credit facility are full and unconditional, joint and several, and Penn has no significant independent assets and no independent operations at, and for the three and six months ended, June 30, 2006. There are no significant restrictions within the $2.725 billion senior secured credit facility on the Company s ability to obtain funds from its subsidiaries by dividend or loan. However, in certain jurisdictions, the gaming authorities may impose restrictions pursuant to the authority granted to them with regard to the Company s ability to obtain funds from its subsidiaries.

With regard to the $2.725 billion senior secured credit facility, the Company has not presented condensed consolidating balance sheets, condensed consolidating statements of income and condensed consolidating statements of cash flows at, and for the three and six months ended, June 30, 2006, as Penn had no significant independent assets and no independent operations at, and for the three and six months ended, June 30, 2006, the guarantees are full and unconditional and joint and several, and any subsidiaries of the parent company other than the subsidiary guarantors are considered minor.

Under the terms of the $200 million 67⁄8% senior subordinated notes, most of the Company s subsidiaries are guarantors. Each of the subsidiary guarantors are 100% owned by Penn. In addition, the guarantees provided by the Company s subsidiaries under the terms of the $200 million 67⁄8% senior subordinated notes are full and unconditional, joint and several, and Penn had no significant independent assets and no independent operations at, and for the three and six months ended, June 30, 2006. There are no significant restrictions within the $200 million 67⁄8% senior subordinated notes on the Company s ability to obtain funds from its subsidiaries by dividend or loan. However, in certain jurisdictions, the gaming authorities may impose restrictions pursuant to the authority granted to them with regard to the Company s ability to obtain funds from its subsidiaries.

Summarized financial information at, and for the three and six months ended, June 30, 2006 and 2005 for Penn, the subsidiary guarantors of the 67⁄8% senior subordinated notes and subsidiary non-guarantors is presented below. For purposes of comparability, certain prior year amounts have been reclassified to conform to the current year presentation.

	Penn	Subsidiary Guarantors	Subsidiary Non-Guarantors	Eliminations	Consolidated
At June 30, 2006					
Condensed Consolidating Balance Sheet (in thousands)					
Current assets	$ (19,954)	$ 287,475	$ 14,412	$ 1,267	$ 283,200
Property and equipment, net	139,022	1,090,024			1,229,046
Other assets	3,318,784	2,859,229	(4,871)	(3,411,539)	2,761,603
Total	$ 3,437,852	$ 4,236,728	$ 9,541	$ (3,410,272)	$ 4,273,849
Current liabilities	(26,218)	299,463	5,632		278,877
Long-term liabilities	2,787,765	3,701,913		(3,171,011)	3,318,667
Shareholders equity	676,305	235,352	3,909	(239,261)	676,305
Total	$ 3,437,852	$ 4,236,728	$ 9,541	$ (3,410,272)	$ 4,273,849
Three months ended June 30, 2006					
Condensed Consolidating Statement of Income (in thousands)					
Net revenues	$	$ 532,916	$ 4,921	$ (64)	$ 537,773
Total operating expenses	16,150	395,071	4,779	(64)	415,936
(Loss) income from operations	(16,150)	137,845	142		121,837
Other expenses	(14,072)	(32,046)	(23)		(46,141)
(Loss) income before income taxes	(30,222)	105,799	119		75,696
Taxes on income	(15,242)	48,132	111		33,001
Net (loss) income	$ (14,980)	$ 57,667	$ 8	$	$ 42,695
Six months ended June 30, 2006					
Condensed Consolidating Statement of Income (in thousands)					
Net revenues	$	$ 1,076,410	$ 9,308	$ (143)	$ 1,085,575
Total operating expenses	31,613	794,368	8,999	(143)	834,837
(Loss) income from operations	(31,613)	282,042	309		250,738
Other expenses	(20,684)	(82,627)	(75)		(103,386)
(Loss) income before income taxes	(52,297)	199,415	234		147,352
Taxes on income	(33,085)	95,542	217		62,674
Net (loss) income	$ (19,212)	$ 103,873	$ 17	$	$ 84,678
Six months ended June 30, 2006					
Condensed Consolidating Statement of Cash Flows (in thousands)					
Net cash provided by (used in) operating activities	$ 88,530	$ (13,393)	$ (329)	$	$ 74,808
Net cash (used in) provided by investing activities	(131,610)	14,548			(117,062)
Net cash provided by (used in) financing activities	40,520	(568)			39,952
Net (decrease) increase in cash and cash equivalents	(2,560)	587	(329)		(2,302)
Cash and cash equivalents at beginning of period	(1,841)	133,862	599		132,620
Cash and cash equivalents at end of period	$ (4,401)	$ 134,449	$ 270	$	$ 130,318

	Penn	Subsidiary Guarantors	Subsidiary Non-Guarantors	Eliminations	Consolidated
At December 31, 2005					