

PENN NATIONAL GAMING INC

Form 10-Q

November 08, 2007

## **UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549



## **FORM 10-Q**



(Mark One)

☒

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

**For the quarterly period ended September 30, 2007**

**OR**

☐

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

**For the transition period from                      to**

Commission file number: 0-24206



**PENN NATIONAL GAMING, INC.**

(Exact name of registrant as specified in its charter)



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**Pennsylvania**

(State or other jurisdiction of  
incorporation or organization)

**23-2234473**

(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)



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

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

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐

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

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

| <b>Title</b>                            | <b>Outstanding as of November 1, 2007</b>                |
|-----------------------------------------|----------------------------------------------------------|
| Common Stock, par value \$.01 per share | 86,653,840 (includes 380,000 shares of restricted stock) |

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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 our expectations are based on reasonable assumptions within the bounds of our knowledge of our business and operations, there can be no assurance that actual results will not differ materially from our expectations. Meaningful factors which could cause actual results to differ from expectations include, but are not limited to, risks related to the following: the possibility that the pending acquisition of the Company by certain funds managed by affiliates of Fortress Investment Group LLC and Centerbridge Partners, L.P. will not be consummated, or will be significantly delayed; the passage of state, federal or local legislation that would expand, restrict, further tax, prevent or negatively impact (such as a smoking ban at any of our facilities) 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; 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; 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, 2006 filed with the United States Securities and Exchange Commission. We do not intend to update publicly any forward-looking statements except as required by law.

**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)**

|                                                                                                                                              | <b>September 30,<br/>2007<br/>(unaudited)</b> | <b>December 31,<br/>2006</b> |
|----------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------|------------------------------|
| <b>Assets</b>                                                                                                                                |                                               |                              |
| <b>Current assets</b>                                                                                                                        |                                               |                              |
| Cash and cash equivalents                                                                                                                    | \$ 179,137                                    | \$ 168,515                   |
| Receivables, net of allowance for doubtful accounts of \$3,301 and \$3,698 at September 30, 2007 and December 31, 2006, respectively         | 50,651                                        | 53,829                       |
| Insurance receivable                                                                                                                         |                                               | 100,000                      |
| Prepaid expenses and other current assets                                                                                                    | 58,405                                        | 57,432                       |
| Deferred income taxes                                                                                                                        | 16,244                                        | 22,187                       |
| Total current assets                                                                                                                         | 304,437                                       | 401,963                      |
| <b>Property and equipment, net</b>                                                                                                           | 1,554,410                                     | 1,365,871                    |
| <b>Other assets</b>                                                                                                                          |                                               |                              |
| Investment in and advances to unconsolidated affiliate                                                                                       | 15,935                                        | 16,138                       |
| Goodwill                                                                                                                                     | 2,010,727                                     | 1,869,444                    |
| Other intangible assets                                                                                                                      | 776,189                                       | 726,126                      |
| Deferred financing costs, net of accumulated amortization of \$24,870 and \$16,438 at September 30, 2007 and December 31, 2006, respectively | 48,954                                        | 57,386                       |
| Other assets                                                                                                                                 | 132,900                                       | 77,154                       |
| Total other assets                                                                                                                           | 2,984,705                                     | 2,746,248                    |
| <b>Total assets</b>                                                                                                                          | \$ 4,843,552                                  | \$ 4,514,082                 |
| <b>Liabilities</b>                                                                                                                           |                                               |                              |
| <b>Current liabilities</b>                                                                                                                   |                                               |                              |
| Current maturities of long-term debt                                                                                                         | \$ 89,187                                     | \$ 40,058                    |
| Accounts payable                                                                                                                             | 34,074                                        | 37,928                       |
| Accrued expenses                                                                                                                             | 108,940                                       | 130,877                      |
| Accrued interest                                                                                                                             | 40,242                                        | 31,329                       |
| Accrued salaries and wages                                                                                                                   | 63,569                                        | 60,164                       |
| Gaming, pari-mutuel, property, and other taxes                                                                                               | 63,876                                        | 48,181                       |
| Income taxes payable                                                                                                                         |                                               | 21,020                       |
| Insurance financing                                                                                                                          | 21,255                                        | 19,336                       |
| Other current liabilities                                                                                                                    | 31,253                                        | 26,778                       |
| Total current liabilities                                                                                                                    | 452,396                                       | 415,671                      |
| <b>Long-term liabilities</b>                                                                                                                 |                                               |                              |
| Long-term debt, net of current maturities                                                                                                    | 2,836,775                                     | 2,789,390                    |
| Deferred income taxes                                                                                                                        | 384,537                                       | 387,615                      |
| Noncurrent tax liabilities                                                                                                                   | 82,146                                        |                              |
| Other noncurrent liabilities                                                                                                                 | 276                                           | 243                          |
| Total long-term liabilities                                                                                                                  | 3,303,734                                     | 3,177,248                    |

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## **Shareholders' equity**

|                                                                                                                                                                  |           |                  |                     |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------|------------------|---------------------|
| Preferred stock (\$.01 par value, 1,000,000 shares authorized, none issued and outstanding at September 30, 2007 and December 31, 2006)                          |           |                  |                     |
| Common stock (\$.01 par value, 200,000,000 shares authorized, 88,333,534 and 86,814,999 shares issued at September 30, 2007 and December 31, 2006, respectively) |           |                  |                     |
|                                                                                                                                                                  |           | 884              | 868                 |
| Treasury stock (1,698,800 shares issued at September 30, 2007 and December 31, 2006)                                                                             |           | (2,379)          | (2,379)             |
| Additional paid-in capital                                                                                                                                       |           | 309,398          | 251,943             |
| Retained earnings                                                                                                                                                |           | 783,455          | 667,557             |
| Accumulated other comprehensive (loss) income                                                                                                                    |           | (3,936)          | 3,174               |
| Total shareholders' equity                                                                                                                                       |           | 1,087,422        | 921,163             |
| <b>Total liabilities and shareholders' equity</b>                                                                                                                | <b>\$</b> | <b>4,843,552</b> | <b>\$ 4,514,082</b> |

See accompanying notes to the consolidated financial statements.

## Penn National Gaming, Inc. and Subsidiaries

## Consolidated Statements of Income

(in thousands, except per share data)

(unaudited)

|                                                              | Three Months Ended September 30, |            | Nine Months Ended September 30, |              |
|--------------------------------------------------------------|----------------------------------|------------|---------------------------------|--------------|
|                                                              | 2007                             | 2006       | 2007                            | 2006         |
| <b>Revenues</b>                                              |                                  |            |                                 |              |
| Gaming                                                       | \$ 574,717                       | \$ 536,901 | \$ 1,694,091                    | \$ 1,531,155 |
| Management service fee                                       | 5,217                            | 4,819      | 13,032                          | 14,127       |
| Food, beverage and other                                     | 82,418                           | 72,273     | 239,082                         | 204,460      |
| Gross revenues                                               | 662,352                          | 613,993    | 1,946,205                       | 1,749,742    |
| Less promotional allowances                                  | (32,902)                         | (27,882)   | (95,253)                        | (78,056)     |
| Net revenues                                                 | 629,450                          | 586,111    | 1,850,952                       | 1,671,686    |
| <b>Operating expenses</b>                                    |                                  |            |                                 |              |
| Gaming                                                       | 296,919                          | 277,747    | 878,296                         | 787,970      |
| Food, beverage and other                                     | 62,476                           | 58,064     | 183,929                         | 166,716      |
| General and administrative                                   | 98,935                           | 91,049     | 291,427                         | 249,565      |
| Depreciation and amortization                                | 37,241                           | 31,196     | 110,221                         | 88,642       |
| Total operating expenses                                     | 495,571                          | 458,056    | 1,463,873                       | 1,292,893    |
| Income from continuing operations                            | 133,879                          | 128,055    | 387,079                         | 378,793      |
| <b>Other income (expenses)</b>                               |                                  |            |                                 |              |
| Interest expense                                             | (50,203)                         | (49,732)   | (149,852)                       | (145,927)    |
| Interest income                                              | 1,020                            | 882        | 3,185                           | 2,652        |
| (Loss) earnings from joint venture                           | (122)                            | (1,665)    | 243                             | (678)        |
| Other                                                        | (2,637)                          | (593)      | (8,341)                         | (519)        |
| Loss on early extinguishment of debt                         |                                  |            |                                 | (10,022)     |
| Total other expenses                                         | (51,942)                         | (51,108)   | (154,765)                       | (154,494)    |
| <b>Income from continuing operations before income taxes</b> |                                  |            |                                 |              |
|                                                              | 81,937                           | 76,947     | 232,314                         | 224,299      |
| Taxes on income                                              | 35,347                           | 36,548     | 104,484                         | 99,222       |
| Net income from continuing operations                        | 46,590                           | 40,399     | 127,830                         | 125,077      |
| Gain on sale of discontinued operations, net of tax          |                                  | 114,661    |                                 | 114,661      |
| <b>Net income</b>                                            | \$ 46,590                        | \$ 155,060 | \$ 127,830                      | \$ 239,738   |
| <b>Earnings per share - Basic</b>                            |                                  |            |                                 |              |
| Income from continuing operations                            | \$ 0.54                          | \$ 0.48    | \$ 1.50                         | \$ 1.49      |
| Discontinued operations, net of tax                          |                                  | 1.36       |                                 | 1.36         |
| <b>Basic earnings per share</b>                              | \$ 0.54                          | \$ 1.84    | \$ 1.50                         | \$ 2.85      |
| <b>Earnings per share - Diluted</b>                          |                                  |            |                                 |              |
| Income from continuing operations                            | \$ 0.52                          | \$ 0.47    | \$ 1.45                         | \$ 1.45      |
| Discontinued operations, net of tax                          |                                  | 1.32       |                                 | 1.32         |
| <b>Diluted earnings per share</b>                            | \$ 0.52                          | \$ 1.79    | \$ 1.45                         | \$ 2.77      |

See accompanying notes to the consolidated financial statements.



## Penn National Gaming, Inc. and Subsidiaries

## Consolidated Statements of Changes in Shareholders' Equity

(in thousands, except share data) (unaudited)

|                                                                                               | Common Stock<br>Shares | Common Stock<br>Amount | Treasury<br>Stock | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total<br>Shareholders'<br>Equity | Comprehensive<br>Income |
|-----------------------------------------------------------------------------------------------|------------------------|------------------------|-------------------|----------------------------------|----------------------|--------------------------------------------------------|----------------------------------|-------------------------|
| Balance, December 31, 2005                                                                    | 85,064,886             | \$ 850                 | \$ (2,379)        | \$ 206,763                       | \$ 340,469           | \$ 840                                                 | \$ 546,543                       |                         |
| Stock option activity,<br>including tax benefit of<br>\$9,405                                 | 1,028,978              | 11                     |                   | 33,249                           |                      |                                                        | 33,260                           | \$                      |
| Restricted stock                                                                              | 440,000                | 4                      |                   | 1,287                            |                      |                                                        | 1,291                            |                         |
| Change in fair value of<br>interest rate swap contracts,<br>net of income taxes of<br>\$1,041 |                        |                        |                   |                                  |                      | 1,823                                                  | 1,823                            | 1,823                   |
| Foreign currency translation<br>adjustment                                                    |                        |                        |                   |                                  |                      | 68                                                     | 68                               | 68                      |
| Net income                                                                                    |                        |                        |                   |                                  | 239,738              |                                                        | 239,738                          | 239,738                 |
| Balance, September 30,<br>2006                                                                | 86,533,864             | \$ 865                 | \$ (2,379)        | \$ 241,299                       | \$ 580,207           | \$ 2,731                                               | \$ 822,723                       | \$ 241,629              |
| Balance, December 31, 2006                                                                    | 86,814,999             | \$ 868                 | \$ (2,379)        | \$ 251,943                       | \$ 667,557           | \$ 3,174                                               | \$ 921,163                       |                         |
| Stock option activity,<br>including tax benefit of<br>\$16,897                                | 1,578,535              | 16                     |                   | 55,985                           |                      |                                                        | 56,001                           | \$                      |
| Restricted stock                                                                              | (60,000)               |                        |                   | 1,470                            |                      |                                                        | 1,470                            |                         |
| Change in fair value of<br>interest rate swap contracts,<br>net of income taxes of<br>\$4,324 |                        |                        |                   |                                  |                      | (7,615)                                                | (7,615)                          | (7,615)                 |
| Foreign currency translation<br>adjustment                                                    |                        |                        |                   |                                  |                      | 505                                                    | 505                              | 505                     |
| Cumulative effect of<br>adoption of FIN 48                                                    |                        |                        |                   |                                  | (11,932)             |                                                        | (11,932)                         |                         |
| Net income                                                                                    |                        |                        |                   |                                  | 127,830              |                                                        | 127,830                          | 127,830                 |
| Balance, September 30,<br>2007                                                                | 88,333,534             | \$ 884                 | \$ (2,379)        | \$ 309,398                       | \$ 783,455           | \$ (3,936)                                             | \$ 1,087,422                     | \$ 120,720              |

See accompanying notes to the consolidated financial statements.

## Penn National Gaming, Inc. and Subsidiaries

## Consolidated Statements of Cash Flows

(in thousands) (unaudited)

| Nine Months Ended September 30,                                                   | 2007          | 2006         |
|-----------------------------------------------------------------------------------|---------------|--------------|
| <b>Operating activities</b>                                                       |               |              |
| Net income                                                                        | \$ 127,830    | \$ 239,738   |
| Adjustments to reconcile net income to net cash provided by operating activities: |               |              |
| Depreciation and amortization                                                     | 110,221       | 88,642       |
| Amortization of items charged to interest expense                                 | 9,777         | 8,551        |
| Loss on sale of fixed assets                                                      | 1,366         | 792          |
| (Earnings) loss from joint venture                                                | (243)         | 678          |
| Loss relating to early extinguishment of debt                                     |               | 2,255        |
| Deferred income taxes                                                             | 11,928        | (14,766)     |
| Charge for stock compensation                                                     | 19,184        | 15,235       |
| Gain on sale of discontinued operations                                           |               | (114,661)    |
| Decrease (increase), net of businesses acquired                                   |               |              |
| Accounts receivable                                                               | 3,608         | (11,225)     |
| Insurance receivable                                                              | 100,000       | (22,809)     |
| Prepaid expenses and other current assets                                         | 5,568         | (23,440)     |
| Other assets                                                                      | (18,594)      | 19,158       |
| (Decrease) increase, net of businesses acquired                                   |               |              |
| Accounts payable                                                                  | (27,325)      | 17,923       |
| Accrued expenses                                                                  | (21,484)      | (9,511)      |
| Accrued interest                                                                  | 1,009         | (2,854)      |
| Accrued salaries and wages                                                        | 3,417         | 4,529        |
| Gaming, pari-mutuel, property and other taxes                                     | 15,626        | 7,868        |
| Income taxes payable                                                              | (4,356)       | 8,663        |
| Noncurrent tax liabilities                                                        | 4,096         |              |
| Other liabilities                                                                 | 4,507         | 2,320        |
| Operating cash flows from discontinued operations                                 |               | 12           |
| Net cash provided by operating activities                                         | 346,135       | 217,098      |
| <b>Investing activities</b>                                                       |               |              |
| Expenditures for property and equipment                                           | (232,061)     | (246,673)    |
| Proceeds from sale of property and equipment                                      | 14,251        | 2,270        |
| Acquisition of businesses and licenses, net of cash acquired                      | (253,078)     |              |
| Net cash used in investing activities                                             | (470,888)     | (244,403)    |
| <b>Financing activities</b>                                                       |               |              |
| Proceeds from exercise of options                                                 | 21,390        | 9,911        |
| Proceeds from issuance of long-term debt                                          | 327,000       | 167,383      |
| Principal payments on long-term debt                                              | (231,831)     | (176,025)    |
| Proceeds from insurance financing                                                 | 25,978        | 29,432       |
| Payments on insurance financing                                                   | (24,059)      | (9,057)      |
| Increase in deferred financing cost                                               |               | (42)         |
| Tax benefit from stock options exercised                                          | 16,897        | 9,405        |
| Net cash provided by financing activities                                         | 135,375       | 31,007       |
| <b>Net increase in cash and cash equivalents</b>                                  | <b>10,622</b> | <b>3,702</b> |
| Cash and cash equivalents at beginning of year                                    | 168,515       | 132,620      |
| Cash and cash equivalents at end of period                                        | \$ 179,137    | \$ 136,322   |

## Supplemental disclosure

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|                       |    |         |    |         |
|-----------------------|----|---------|----|---------|
| Interest expense paid | \$ | 147,732 | \$ | 148,216 |
| Income taxes paid     | \$ | 85,475  | \$ | 94,069  |

See accompanying notes to the consolidated financial statements.

**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, 2006 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 nine months ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007.

**2. Merger Announcement**

On June 15, 2007, the Company announced that it had entered into a merger agreement that would ultimately result in the Company's shareholders receiving \$67.00 per share. Specifically, the Company, PNG Acquisition Company Inc. ( Parent ) and PNG Merger Sub Inc., a wholly-owned subsidiary of Parent ( Merger Sub ), announced that they had entered into an Agreement and Plan of Merger, dated as of June 15, 2007 (the Merger Agreement ), that provides, among other things, for Merger Sub to be merged with and into the Company (the Merger ), as a result of which the Company will continue as the surviving corporation and a wholly-owned subsidiary of Parent. Parent is owned by certain funds (the Funds ) managed by affiliates of Fortress Investment Group LLC ( Fortress ) and Centerbridge Partners, L.P. ( Centerbridge ).

Pursuant to the Merger Agreement, at the effective time of the Merger, each outstanding share of common stock of the Company (the Common Stock ), other than shares held by the Company as treasury stock or owned directly or indirectly by Parent or Merger Sub, will be cancelled and converted into the right to receive \$67.00 in cash, without interest. In the event that the Merger shall not have occurred by June 15, 2008 (the Adjustment Date ), the \$67.00 cash amount per share of Common Stock shall be increased for each day after the Adjustment Date, through and including the closing date, by adding an amount equal to \$0.0149 per day.

The Merger Agreement provides that, upon termination under specified circumstances generally related to a competing acquisition proposal, the Company would be required to pay a termination fee of up to \$200 million to Parent and, under certain circumstances if the Company's shareholders do not approve the Merger, the Company must reimburse Parent for an amount not to exceed \$17.5 million for transaction expenses incurred by Parent and its affiliates. The Company's reimbursement of Parent's expenses would reduce the amount of any required termination fee that becomes payable by the Company. The Merger Agreement further provides that, upon termination under specified circumstances related to, among other things, Parent's breach of the Merger Agreement, the failure to obtain financing or failure to obtain regulatory approval, Parent would be required to pay the Company a termination fee of \$200 million. Affiliates of the Funds have agreed to fund Parent in the amount of the termination fee in the event it becomes payable.

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Parent has obtained equity and debt financing commitments for the transactions contemplated by the Merger Agreement, the proceeds of which will be used by Parent to pay the aggregate Merger consideration and related fees and expenses of the transactions contemplated by the Merger Agreement and to repay certain debt of the Company and its subsidiaries. Consummation of the Merger is not subject to a financing condition, but is subject to customary conditions to closing, including the approval of the Company's shareholders and regulatory approvals.

On November 7, 2007, the Company announced that it has established a November 7, 2007 record date and a meeting date of December 12, 2007 for a special meeting at which its shareholders will be asked to consider and vote upon a proposal to approve and adopt the Merger Agreement.

### 3. **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, for chips and ticket-in, ticket-out coupons in the customers' possession and for accruals related to the anticipated payout of progressive jackpots.

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

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Food, beverage and other revenue, including racing revenue, is recognized as services are performed. Racing revenue includes the Company's share of pari-mutuel wagering on live races after payment of amounts returned as winning wagers, its share of wagering from import and export simulcasting, and its share of wagering from its off-track wagering facilities ( OTWs ).

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.

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 food, beverage and other expense. The amounts included in promotional allowances for the three and nine months ended September 30, 2007 and 2006 are as follows:

|                              | Three Months Ended September 30, |           | Nine Months Ended September 30, |           |
|------------------------------|----------------------------------|-----------|---------------------------------|-----------|
|                              | 2007                             | 2006      | 2007                            | 2006      |
|                              | (in thousands)                   |           | (in thousands)                  |           |
| Rooms                        | \$ 4,164                         | \$ 3,200  | \$ 11,402                       | \$ 8,780  |
| Food and beverage            | 26,037                           | 22,950    | 76,955                          | 62,186    |
| Other                        | 2,701                            | 1,732     | 6,896                           | 7,090     |
| Total promotional allowances | \$ 32,902                        | \$ 27,882 | \$ 95,253                       | \$ 78,056 |

The estimated cost of providing such complimentary services for the three and nine months ended September 30, 2007 and 2006 are as follows:

|                                      | Three Months Ended September 30, |           | Nine Months Ended September 30, |           |
|--------------------------------------|----------------------------------|-----------|---------------------------------|-----------|
|                                      | 2007                             | 2006      | 2007                            | 2006      |
|                                      | (in thousands)                   |           | (in thousands)                  |           |
| Rooms                                | \$ 1,580                         | \$ 1,341  | \$ 4,833                        | \$ 3,656  |
| Food and beverage                    | 18,274                           | 15,737    | 53,280                          | 43,322    |
| Other                                | 1,462                            | 939       | 3,833                           | 4,552     |
| Total cost of complimentary services | \$ 21,316                        | \$ 18,017 | \$ 61,946                       | \$ 51,530 |

### 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 66,736 and 1,445,057 shares of common stock were outstanding during the three and nine months ended September 30, 2007, respectively, but were not included in the computation of diluted earnings per share because they are antidilutive. Options to purchase 2,147,084 and 2,090,016 shares of common stock were outstanding during the three and nine months ended September 30, 2006, respectively, but were not included in the computation of

diluted earnings per share because they are antidilutive.

|                                                    | Three Months Ended September 30, |        | Nine Months Ended September 30, |        |
|----------------------------------------------------|----------------------------------|--------|---------------------------------|--------|
|                                                    | 2007                             | 2006   | 2007                            | 2006   |
|                                                    | (in thousands)                   |        | (in thousands)                  |        |
| Determination of shares:                           |                                  |        |                                 |        |
| Weighted-average common shares outstanding         | 85,931                           | 84,385 | 85,336                          | 84,124 |
| Assumed conversion of dilutive stock options       | 2,882                            | 2,195  | 2,803                           | 2,381  |
| Diluted weighted-average common shares outstanding | 88,813                           | 86,580 | 88,139                          | 86,505 |

### 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 were not restated.

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 4.73 years, in order to match the expected life of the options at 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. The following are the weighted-average assumptions used in the Black-Scholes option-pricing model at September 30, 2007 and 2006:

|                                        | Nine Months Ended September 30, |        |
|----------------------------------------|---------------------------------|--------|
|                                        | 2007                            | 2006   |
| Risk-free interest rate                | 4.24%                           | 5.11%  |
| Expected volatility                    | 37.68%                          | 43.29% |
| Dividend yield                         |                                 |        |
| Weighted-average expected life (years) | 4.73                            | 4.26   |
| Forfeiture rate                        | 4.00%                           | 4.00%  |

### 4. New Accounting Pronouncements

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In September 2006, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 157, Fair Value Measurements ( SFAS 157 ), which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 applies under other accounting pronouncements that require or permit fair value measurements, but does not require any new fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently determining the impact of SFAS 157 on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities-including an amendment of SFAS No. 115 ( SFAS 159 ), which permits an entity to choose to measure many financial instruments and certain other items at fair value. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS 159 is effective as of the

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beginning of each reporting entity's first fiscal year that begins after November 15, 2007. The Company is currently determining the impact of SFAS 159 on its consolidated financial statements.

The Company accounts for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes (SFAS 109). Under SFAS 109, deferred tax assets and liabilities are determined based on the differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities and are measured at the prevailing enacted tax rates that will be in effect when these differences are settled or realized. SFAS 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax assets will not be realized.

The realizability of the deferred tax assets is evaluated quarterly by assessing the valuation allowance and by adjusting the amount of the allowance, if necessary. The factors used to assess the likelihood of realization are the forecast of future taxable income and available tax planning strategies that could be implemented to realize the net deferred tax assets. The Company has used tax-planning strategies to realize or renew net deferred tax assets in order to avoid the potential loss of future tax benefits.

The Company adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48) on January 1, 2007. As a result of the implementation of FIN 48, the Company recognized a liability for unrecognized tax benefits of approximately \$11.9 million, which was accounted for as a reduction to the January 1, 2007 retained earnings balance. The liability for unrecognized tax benefits is included in noncurrent tax liabilities within the consolidated balance sheet at September 30, 2007.

A reconciliation of the beginning and ending amount for the liability for unrecognized tax benefits is as follows:

|                                               | <b>Noncurrent<br/>tax liabilities<br/>(in thousands)</b> |
|-----------------------------------------------|----------------------------------------------------------|
| Balance at January 1, 2007                    | \$ 56,960                                                |
| Additions based on current year tax positions | 2,038                                                    |
| Additions based on prior year tax positions   | 9,788                                                    |
| Currency translation adjustments              | 13,360                                                   |
| Balance at September 30, 2007                 | \$ 82,146                                                |

Included in the liability for unrecognized tax benefits at September 30, 2007 were \$36.7 million of tax positions that are indemnified by a third party. The receivable for this indemnification is included in other assets within the consolidated balance sheet at September 30, 2007.

Included in the liability for unrecognized tax benefits at September 30, 2007 were \$13.4 million of currency translation adjustments for foreign currency tax positions.

Included in the liability for unrecognized tax benefits at September 30, 2007 were \$24.7 million of tax positions that, if reversed, would affect the effective tax rate.

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During the three and nine months ended September 30, 2007, as well as prior to January 1, 2007, the Company recognized interest and penalties accrued related to unrecognized tax benefits in taxes on income within the consolidated statements of income.

During the three and nine months ended September 30, 2007, the Company recognized approximately \$1.1 million and \$2.6 million of interest and penalties, respectively. The Company has accrued approximately \$39.2 million for the payment of interest and penalties at September 30, 2007. These accruals were included in noncurrent tax liabilities within the consolidated balance sheet at September 30, 2007.

**As of January 1, 2007, the Company is subject to U.S. Federal income tax examinations for the tax years 2005 and 2006. In addition, the Company is subject to state and local income tax examinations for various tax years in the taxing jurisdictions in which we operate.**

## 5. Acquisitions

On April 16, 2007, pursuant to the Asset Purchase Agreement dated November 7, 2006 among Zia Partners, LLC ( "Zia"), Zia Park LLC (the "Buyer"), a wholly-owned subsidiary of Penn, and (solely with respect to specified sections thereof which relate to the Company's guarantee of the Buyer's payment and performance) Penn, the Buyer completed the acquisition of the Black Gold Casino and Zia Park Racetrack and all related assets of Zia. Penn funded this purchase with additional borrowings under its existing \$750 million revolving credit facility. The Company accounted for the acquisition in accordance with SFAS No. 141, "Business Combinations". As a result of the acquisition, the Company recorded goodwill of \$143.7 million and other intangible assets of \$4.6 million, both of which are subject to a final purchase price allocation. The results of operations of the Black Gold Casino and Zia Park Racetrack have been included in the Company's consolidated financial statements since the acquisition date.

On July 5, 2007, the Company announced that it had entered into a definitive agreement to purchase the Sanford-Orlando Kennel Club in Longwood, Florida from Sanford-Orlando Kennel Club, Inc. and Collins & Collins. In connection with the purchase agreement, the Company also secured a right of first refusal with respect to a majority stake in the Sarasota Kennel Club in Sarasota, Florida from Jack G. Collins, Sr. and members of his family. The purchase price for the Sanford-Orlando Kennel Club contemplated additional consideration to be paid by the Company based upon certain future regulatory developments. Located on approximately 26 acres in Longwood, Florida, the Sanford-Orlando Kennel Club features year-round greyhound racing, a simulcast wagering facility, a clubhouse lounge and two dining areas.

On September 11, 2007, the Company announced that it had executed a definitive agreement to purchase Rosecroft Raceway in Fort Washington, Maryland from Cloverleaf Enterprises, Inc. Pursuant to regulatory approvals received on October 23, 2007, the transaction is expected to close on November 30, 2007. Rosecroft Raceway is a harness racing facility located on 130 acres that runs 88 days of live standardbred racing a year and features a simulcast wagering facility, a clubhouse lounge and a dining area overlooking the live action on the racetrack.

## 6. 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, Hollywood Casino Bay St. Louis and Boomtown Biloxi, were significantly damaged, many employees were displaced and operations ceased at the two properties. Boomtown Biloxi reopened on June 29, 2006 and Hollywood Casino Bay St. Louis reopened on August 31, 2006.

During the year ended December 31, 2006, the Company's financial results benefited from a settlement agreement with its property and business interruption insurance providers for a total of \$225 million for Hurricane Katrina-related losses at its Hollywood Casino Bay St. Louis and Boomtown Biloxi properties, as well as minor proceeds related to its National Flood Insurance coverage and auto insurance claims.

The \$100 million insurance receivable recorded at December 31, 2006 represented the portion of the \$225 million settlement that was received in January 2007.

In June 2007, the Company renewed its first layer of property insurance coverage in the amount of \$200 million. The \$200 million coverage, which is effective from August 8, 2007 through December 31, 2010, is on an "all risk" basis, including, but not limited to, coverage for "named

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windstorms, floods and earthquakes. Also, the Company purchased an additional \$400 million of all risk coverage that is subject to certain exclusions including, among others, exclusions for named windstorms, floods and earthquakes. The additional \$400 million coverage is effective from August 8, 2007 through June 1, 2008. There is a \$25 million deductible for named windstorm events, and lesser deductibles as they apply to other perils. Both layers are subject to specific policy terms, conditions and exclusions.

### 7. **Property and Equipment**

Property and equipment, net, consists of the following:

|                                                | September 30,<br>2007 | December 31,<br>2006 |
|------------------------------------------------|-----------------------|----------------------|
|                                                | (in thousands)        |                      |
| Land and improvements                          | \$ 183,487            | \$ 190,002           |
| Building and improvements                      | 992,905               | 868,577              |
| Furniture, fixtures and equipment              | 482,206               | 420,809              |
| Transportation equipment                       | 2,975                 | 2,392                |
| Leasehold improvements                         | 15,873                | 15,005               |
| Construction in progress                       | 292,837               | 187,531              |
| Total property and equipment                   | 1,970,283             | 1,684,316            |
| Less accumulated depreciation and amortization | (415,873)             | (318,445)            |
| Property and equipment, net                    | \$ 1,554,410          | \$ 1,365,871         |

Depreciation expense for property and equipment totaled \$35.3 million and \$104.6 million for the three and nine months ended September 30, 2007, respectively, as compared to \$29.5 million and \$83.7 million for the three and nine months ended September 30, 2006, respectively. Interest capitalized in connection with major construction projects was \$3.7 million and \$9.4 million for the three and nine months ended September 30, 2007, respectively, as compared to \$2.3 and \$5.6 million for the three and nine months ended September 30, 2006, respectively.

## 8. Goodwill and Other Intangible Assets

The Company's goodwill and intangible assets had a gross carrying value of \$2.8 billion and \$2.6 billion at September 30, 2007 and December 31, 2006, respectively, and accumulated amortization of \$25.1 million and \$19.4 million at September 30, 2007 and December 31, 2006, 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 September 30, 2007 and December 31, 2006:

|                                  | September 30,<br>2007   |                             |                | December 31,<br>2006    |                             |                |
|----------------------------------|-------------------------|-----------------------------|----------------|-------------------------|-----------------------------|----------------|
|                                  | (in thousands)          |                             |                |                         |                             |                |
|                                  | Gross<br>Carrying Value | Accumulated<br>Amortization | Net Book Value | Gross<br>Carrying Value | Accumulated<br>Amortization | Net Book Value |
| Goodwill                         | \$ 2,010,727            | \$                          | \$ 2,010,727   | \$ 1,869,444            | \$                          | \$ 1,869,444   |
| Gaming license and<br>trademarks | 751,966                 |                             | 751,966        | 700,434                 |                             | 700,434        |
| Other intangible assets          | 49,316                  | 25,093                      | 24,223         | 45,126                  | 19,434                      | 25,692         |
| Total                            | \$ 2,812,009            | \$ 25,093                   | \$ 2,786,916   | \$ 2,615,004            | \$ 19,434                   | \$ 2,595,570   |

During the nine months ended September 30, 2007, goodwill increased by \$141.3 million, primarily due to goodwill recorded as part of the completion of the Black Gold Casino and Zia Park Racetrack acquisition in April 2007, offset by deferred tax adjustments relating to litigation accruals. In addition, gaming license and trademarks increased by \$51.5 million during the nine months ended September 30, 2007, due to the Black Gold Casino and Zia Park Racetrack acquisition and payment for the Category 1 slot machine license for the placement of slot machines at the Company's planned Hollywood Casino at Penn National Race Course.

The Company's intangible asset amortization expense was \$1.9 million and \$5.6 million for the three and nine months ended September 30, 2007, respectively, as compared to \$1.7 million and \$5.0 million for the three and nine months ended September 30, 2006, respectively.

The following table presents expected intangible asset amortization expense based on existing intangible assets at September 30, 2007 (in thousands):

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|                 |    |        |
|-----------------|----|--------|
| 2007 (3 months) | \$ | 1,949  |
| 2008            |    | 7,626  |
| 2009            |    | 6,626  |
| 2010            |    | 5,757  |
| 2011            |    | 2,080  |
| Thereafter      |    | 185    |
| Total           | \$ | 24,223 |

## 9. Long-term Debt

Long-term debt, net of current maturities, is as follows:

|                                                                         | September 30,<br>2007 | December 31,<br>2006 |
|-------------------------------------------------------------------------|-----------------------|----------------------|
|                                                                         | (in thousands)        |                      |
| Senior secured credit facility                                          | \$ 2,440,000          | \$ 2,343,875         |
| \$200 million 6 <sup>7</sup> / <sub>8</sub> % senior subordinated notes | 200,000               | 200,000              |
| \$250 million 6 <sup>3</sup> / <sub>4</sub> % senior subordinated notes | 250,000               | 250,000              |
| Other long-term obligations                                             | 26,386                | 25,041               |
| Capital leases                                                          | 9,576                 | 10,532               |
|                                                                         | 2,925,962             | 2,829,448            |
| Less current maturities of long-term debt                               | (89,187)              | (40,058)             |
|                                                                         | \$ 2,836,775          | \$ 2,789,390         |

The following is a schedule of future minimum repayments of long-term debt at September 30, 2007 (in thousands):

|                        |              |
|------------------------|--------------|
| Within one year        | \$ 89,187    |
| 1-3 years              | 210,519      |
| 3-5 years              | 1,986,566    |
| Over 5 years           | 639,690      |
| Total minimum payments | \$ 2,925,962 |

At September 30, 2007, the Company was contingently obligated under letters of credit issued pursuant to the \$2.725 billion senior secured credit facility with face amounts aggregating \$30.6 million.

### 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 Gaming Company (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 \$2.725 billion senior secured credit facility consists of three credit facilities comprised of a \$750 million revolving credit facility (of which \$498 million was drawn at September 30, 2007), a \$325 million Term Loan A facility and a \$1.65 billion Term Loan B facility. The \$2.725 billion senior secured credit facility also allows the Company to raise an additional \$300 million in senior secured credit for project development and property expansion.

The \$2.725 billion 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 that 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 \$2.725 billion senior secured credit facility. On October 25, 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 effective date of the four contracts was October 27, 2005, and the annual weighted-average interest rate of the four contracts is 4.71%. On April 6, 2006, the Company entered into three interest rate swap contracts with terms of five years and notional amounts of \$100 million each, for a total of \$300 million and fixed interest rates ranging from 5.263% to 5.266%. The effective date of the three contracts was May 8, 2006, and the annual weighted-average interest rate of the three contracts is 5.26%. On September 5, 2007, the Company entered into two interest rate swap contracts with terms of nine months and notional amounts of \$197 million and \$181 million, for a total of \$378 million, and fixed interest rates of 5.01%. The effective date of the \$197 million contract was September 17, 2007, and the effective date of the \$181 million contract was October 18, 2007. Under all of these contracts, the Company pays a fixed interest rate against a variable interest rate based on the 90-day LIBOR rate. The applicable 90-day LIBOR rate as of September 30, 2007 for the \$960 million swaps and the \$300 million swaps was 5.36%. The applicable 90-day LIBOR rate as of September 30, 2007 relating to the \$197 million swap was 5.69%. The applicable 90-day LIBOR rate as of October 18, 2007 relating to the \$181 million swap was 5.21%.

## Redemption of 8<sup>7</sup>/<sub>8</sub>% Senior Subordinated Notes

In February 2006, the Company called for the redemption of its \$175 million 8<sup>7</sup>/<sub>8</sub>% 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 recorded a \$10.0 million loss on early extinguishment of debt during the nine months ended September 30, 2006 for the call premium and the write-off of the associated deferred financing fees. The Company funded the redemption of the notes from available cash and borrowings under its revolving credit facility.

## 6<sup>7</sup>/<sub>8</sub>% Senior Subordinated Notes

On December 4, 2003, the Company completed an offering of \$200 million of 6<sup>7</sup>/<sub>8</sub>% 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 may redeem all or part of the notes on or after December 1, 2007 at certain specified redemption prices.

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The 6<sup>7</sup>/<sub>8</sub>% 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 6<sup>7</sup>/<sub>8</sub>% notes rank equally with the Company's future senior subordinated debt and junior to its senior debt, including debt under the Company's \$2.725 billion senior secured credit facility. In addition, the 7<sup>1</sup>/<sub>8</sub>% notes will be effectively junior to any indebtedness of Penn's non-U.S. unrestricted subsidiaries.

The 6<sup>7</sup>/<sub>8</sub>% 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.

### **6<sup>3</sup>/<sub>4</sub>% Senior Subordinated Notes**

On March 9, 2005, the Company completed an offering of \$250 million of 6<sup>3</sup>/<sub>4</sub>% senior subordinated notes that mature on March 1, 2015. Interest on the notes is payable on March 1 and September 1 of each year, beginning September 1,

2005. The 6<sup>3</sup>/<sub>4</sub>% notes are general unsecured obligations and are not guaranteed by the Company's subsidiaries. The 8<sup>3</sup>/<sub>4</sub>% notes were issued in a private placement pursuant to an exemption from the registration requirements of the Securities Act.

### Other Long-Term Obligations

On October 15, 2004, the Company announced the sale of The Downs Racing, Inc. and its subsidiaries to the Mohegan Tribal Gaming Authority (the "MTGA"). Under the terms of the agreement, the MTGA acquired The Downs Racing, Inc. and its subsidiaries, including Pocono Downs (a standardbred horse racing facility located on 400 acres in Wilkes-Barre, Pennsylvania) and five Pennsylvania off-track wagering facilities located in Carbondale, East Stroudsburg, Erie, Hazleton and the Lehigh Valley (Allentown). The sale agreement also provided the MTGA with certain post-closing termination rights in the event of certain materially adverse legislative or regulatory events. In January 2005, the Company received \$280 million from the MTGA and transferred the operations of The Downs Racing, Inc. and its subsidiaries to the MTGA. The sale was not considered final for accounting purposes until the third quarter of 2006, as the MTGA had certain post-closing termination rights that remained outstanding. On August 7, 2006, the Company entered into the Second Amendment to the Purchase Agreement and Release of Claims ("Amendment and Release") with the MTGA pertaining to the October 14, 2004 Purchase Agreement (the "Purchase Agreement") and agreed to pay the MTGA an aggregate of \$30 million over five years, beginning on the first anniversary of the commencement of slot operations at Mohegan Sun at Pocono Downs, in exchange for the MTGA's agreement to release various claims it raised against the Company under the Purchase Agreement and the MTGA's surrender of all post-closing termination rights it might have had under the Purchase Agreement. The Company recorded the present value of the \$30 million liability within debt, as the amount due to the MTGA is payable over five years, with the first payment to occur in November 2007.

### Covenants

The Company's \$2.725 billion senior secured credit facility, \$200 million 8<sup>3</sup>/<sub>4</sub>% and \$250 million 6<sup>3</sup>/<sub>4</sub>% 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 \$2.725 billion senior secured credit facility, \$200 million 8<sup>3</sup>/<sub>4</sub>% and \$250 million 6<sup>3</sup>/<sub>4</sub>% 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 September 30, 2007, the Company was in compliance with all required covenants.

## 10. Commitments and Contingencies

### Litigation



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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 November 2005, Capital Seven, LLC and Shawn A. Scott (collectively, "Capital Seven"), the sellers of Bangor Historic Track, Inc. ("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 Capital Seven claims 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. Pursuant to the dispute resolution procedures, the Company deposited \$30 million in escrow, pending a resolution.

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This amount is included in other assets within the consolidated balance sheets at September 30, 2007 and December 31, 2006. The parties are actively involved in discovery, and arbitration is currently scheduled for April 2008.

In conjunction with the Company's acquisition of Argosy, and subsequent disposition of the Argosy Casino Baton Rouge property, 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, 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. On October 2, 2006, the Company prevailed on a partial summary judgment motion which limited plaintiff's damages to its out-of-pocket costs in seeking its gaming license, thereby eliminating any recovery for potential lost gaming profits. On February 6, 2007, the jury returned a verdict of \$3.8 million (exclusive of statutory interest and attorneys fees) against Jazz Enterprises, Inc. and Argosy. After ruling on post-trial motions, on September 27, 2007, the trial court entered a judgment in the amount of \$1.4 million, plus attorney fees, costs and interest. The Company has established an appropriate reserve and will bond the judgment pending its appeal. 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.

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. 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 casinos began paying the 3% tax surcharge into a protest fund which accrues interest during the pendency of the lawsuit. The accumulated funds will be returned to the casinos if they ultimately prevail in the lawsuit. In two orders dated March 29, 2007 and April 20, 2007, the Court declared the law unconstitutional under the Uniformity Clause of the Illinois Constitution and enjoined the collection of this tax surcharge. The State of Illinois requested, and was granted, a stay of this ruling. As a result, the casinos will continue paying the 3% tax surcharge into the protest fund until a final order has been entered in the case. The State of Illinois has appealed the ruling to the Illinois Supreme Court. The Company anticipates the appeal will take several months before a final ruling is reached on this matter.

In August 2007, a complaint was filed on behalf of a putative class of public shareholders of the Company, and derivatively on behalf of the Company, in the Court of Common Pleas of Berks County, Pennsylvania (the Complaint). The Complaint names our Board of Directors as defendants and the Company as a nominal defendant. The Complaint alleges, among other things, that the Board of Directors breached their fiduciary duties by agreeing to the proposed transaction with Fortress and Centerbridge for inadequate consideration, that certain members of the Board of Directors have conflicts with regard to the Merger, and that the Company and its Board of Directors have failed to disclose certain material information with regard to the Merger. The Complaint seeks, among other things, a court order: determining that the action is properly maintained as a class action and a derivative action; enjoining the Company and its Board of Directors from consummating the proposed Merger; and awarding the payment of attorneys' fees and expenses. The Company believes that the case is without merit.

### Operating Lease Commitments

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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 \$8.0 million and \$23.8 million for the three and nine months ended September 30, 2007, respectively, as compared to \$7.9 million and \$20.9 million for the three and nine months ended September 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 third quarter of 2008, at a budgeted cost of \$131 million. This permanent facility, which will be called Hollywood Slots Hotel and Raceway, 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.

On March 23, 2007, BTN, Inc. ( "BTN" ), one of the Company's wholly-owned subsidiaries, entered into an amended and restated ground lease (the "Amended Lease") with Skrametta MS, LLC. The lease amends the prior ground lease, dated October 19, 1993. The Amended Lease requires BTN to maintain a minimum gaming operation on the leased premises and to pay rent equal to 5% of adjusted gaming win after gaming taxes have been deducted. The term of the Amended Lease expires on January 1, 2093.

The future minimum lease commitments relating to the base lease rent portion of noncancelable operating leases at September 30, 2007 are as follows (in thousands):

|                 |    |        |
|-----------------|----|--------|
| Within one year | \$ | 8,585  |
| 1-3 Years       |    | 12,223 |
| 3-5 Years       |    | 8,981  |
| Over 5 years    |    | 30,563 |
| Total           | \$ | 60,352 |

## Capital Expenditure Commitments

At September 30, 2007, the Company is contractually committed to spend approximately \$181.8 million in capital expenditures for projects in progress.

## 11. 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, but options granted prior to the 1994 Plan's termination remain outstanding.

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

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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 (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 September 30, 2007 and December 31, 2006, there were 3,204,225 and 4,182,600 options available for future grants under the 2003 Plan, respectively.

Stock options that expire between January 2, 2008 and January 2, 2017 have been granted to officers, directors and employees to purchase Common Stock at prices ranging from \$2.58 to \$61.60 per share. All options were granted at the fair market value of the Common Stock on the date the options were granted.

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The following table contains information on stock options issued under the plans for the nine months ended September 30, 2007 and 2006:

|                                   | Number of Option<br>Shares | Weighted-Average<br>Exercise Price | Weighted-<br>Average<br>Remaining<br>Contractual<br>Term (in years) | Aggregate<br>Intrinsic Value<br>(in thousands) |
|-----------------------------------|----------------------------|------------------------------------|---------------------------------------------------------------------|------------------------------------------------|
| Outstanding at December 31, 2005  | 7,733,814                  | \$ 17.09                           | 5.34                                                                | \$ 122,844                                     |
| Granted                           | 1,746,500                  | 33.24                              |                                                                     |                                                |
| Exercised                         | (1,028,978)                | 9.63                               |                                                                     |                                                |
| Canceled                          | (92,500)                   | 21.57                              |                                                                     |                                                |
| Outstanding at September 30, 2006 | 8,358,836                  | \$ 21.33                           | 5.13                                                                | \$ 145,835                                     |
| Exercisable at September 30, 2006 | 2,954,836                  | \$ 13.51                           | 3.83                                                                | \$ 74,681                                      |
| Outstanding at December 31, 2006  | 8,110,601                  | \$ 21.87                           | 4.97                                                                | \$ 160,225                                     |
| Granted                           | 1,447,750                  | 42.08                              |                                                                     |                                                |
| Exercised                         | (1,578,535)                | 13.55                              |                                                                     |                                                |
| Canceled                          | (480,375)                  | 28.36                              |                                                                     |                                                |
| Outstanding at September 30, 2007 | 7,499,441                  | \$ 27.10                           | 5.05                                                                | \$ 239,164                                     |
| Exercisable at September 30, 2007 | 3,222,791                  | \$ 19.28                           | 4.05                                                                | \$ 127,965                                     |

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 September 30, 2007 and December 31, 2006, the number of these common stock options that were outstanding was 23,750. 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 restricted stock grants in 2004 and 2006 were made pursuant to the 2003 Plan. Due to the departure of one of the Company's senior executives, 60,000 of these awards were forfeited. The weighted-average grant-date fair value of options granted during the three and nine months ended September 30, 2007 was \$22.77 and \$16.03, respectively, as compared to \$13.90 and \$14.55 during the three and nine months ended September 30, 2006, respectively.

The aggregate intrinsic value of stock options exercised during the three and nine months ended September 30, 2007 was \$42.5 million and \$63.6 million, respectively, as compared to \$1.0 million and \$28.7 million during the three and nine months ended September 30, 2006, respectively.

The following table summarizes information about stock options outstanding at September 30, 2007:

|                                                     | Exercise Price Range   |                         |                         |                                 |
|-----------------------------------------------------|------------------------|-------------------------|-------------------------|---------------------------------|
|                                                     | \$ 2.58 to<br>\$ 29.22 | \$ 30.18 to<br>\$ 41.62 | \$ 42.43 to<br>\$ 61.60 | Total<br>\$ 2.58 to<br>\$ 61.60 |
| <b>Outstanding options</b>                          |                        |                         |                         |                                 |
| Number outstanding                                  | 4,364,874              | 3,053,567               | 81,000                  | 7,499,441                       |
| Weighted-average remaining contractual life (years) | 4.12                   | 6.35                    | 6.61                    | 5.05                            |
| Weighted-average exercise price                     | \$ 19.75               | \$ 37.00                | \$ 50.01                | \$ 27.10                        |
| <b>Exercisable options</b>                          |                        |                         |                         |                                 |
| Number outstanding                                  | 2,796,874              | 425,917                 |                         | 3,222,791                       |
| Weighted-average exercise price                     | \$ 17.15               | \$ 33.31                | \$                      | \$ 19.28                        |

Compensation costs related to stock-based compensation for the three and nine months ended September 30, 2007 totaled \$6.3 million pre-tax (\$4.6 million after-tax) and \$19.2 million pre-tax (\$13.9 million after-tax), respectively, as compared to \$4.8 million pre-tax (\$4.2 million after-tax) and \$15.2 million pre-tax (\$11.0 million after-tax) for the three and nine months ended September 30, 2006, respectively. These are included within the consolidated statements of income under general and administrative expense.

At September 30, 2007 and December 31, 2006, the total compensation cost related to nonvested awards not yet recognized equaled \$47.6 million and \$45.2 million, respectively, including \$41.8 million and \$38.0 million for stock options, respectively, and \$5.8 million and \$7.2 million for restricted stock, respectively. This cost is expected to be recognized over the remaining vesting periods, which will not exceed five years.

## 12. Subsidiary Guarantors

Under the terms of the \$2.725 billion senior secured credit facility, all of Penn's subsidiaries are guarantors under the agreement, with the exception of several minor subsidiaries with total assets, excluding intercompany balances, of \$33.3 million (approximately .7% of total assets at September 30, 2007). Each of the subsidiary guarantors is 100% owned by Penn. In addition, the guarantees provided by Penn'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 nine months ended, September 30, 2007. 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 Penn'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 nine months ended, September 30, 2007 and 2006, as Penn had no significant independent assets and no independent operations at, and for the three and nine months ended, September 30, 2007, the guarantees are full and unconditional and joint and several, and any subsidiaries of Penn other than the subsidiary guarantors are considered minor.

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Under the terms of the \$200 million  $6\frac{7}{8}\%$  senior subordinated notes, all of Penn's subsidiaries are guarantors under the agreement, with the exception of several minor subsidiaries with total assets, excluding intercompany balances, of \$22.2 million (approximately .5% of total assets at September 30, 2007). Each of the subsidiary guarantors is 100% owned by Penn. In addition, the guarantees provided by Penn's subsidiaries under the terms of the \$200 million  $6\frac{7}{8}\%$  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 nine months ended September 30, 2007. There are no significant restrictions within the \$200 million  $6\frac{7}{8}\%$  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 Penn's ability to obtain funds from its subsidiaries.

With regard to the \$200 million  $6\frac{7}{8}\%$  senior subordinated notes, 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 nine months ended, September 30, 2007 and 2006, as Penn had no significant independent assets and no independent operations, and for the three and nine months ended, September 30, 2007, the guarantees are full and unconditional and joint and several, and any subsidiaries of Penn other than the subsidiary guarantors are considered minor.

**13. Discontinued Operations Sale of The Downs Racing, Inc. and Subsidiaries**

On October 15, 2004, the Company announced the sale of The Downs Racing, Inc. and its subsidiaries to the MTGA. In January 2005, the Company received \$280 million from the MTGA, and transferred the operations of The Downs Racing, Inc. and its subsidiaries to the MTGA. The sale was not considered final for accounting purposes until the third quarter of 2006, as the MTGA had certain post-closing termination rights that remained outstanding. On August 7, 2006, the Company entered into the Amendment and Release with the MTGA pertaining to the Purchase Agreement, and agreed to pay the MTGA an aggregate of \$30 million over five years, beginning on the first anniversary of the commencement of slot operations at Mohegan Sun at Pocono Downs, in exchange for the MTGA's agreement to release various claims it raised against the Company under the Purchase Agreement and the MTGA's surrender of all post-closing termination rights it might have had under the Purchase Agreement. As a result of the Amendment and Release, the Company recorded, in accordance with GAAP, a net book gain on the \$250 million sale (\$280 million initial price, less \$30 million payable pursuant to the Amendment and Release) of The Downs Racing, Inc. and its subsidiaries to the MTGA of \$114.7 million (net of \$84.3 million of income taxes) during the three and nine months ended September 30, 2006. In addition, the Company recorded the present value of the \$30 million liability within debt, as the amount due to the MTGA is payable over five years, with the first payment to occur in November 2007.

**14. Subsequent Event**

On October 17, 2007, the Company announced that, following the approval by Florida's Department of Business and Professional Regulation, it had completed its purchase of the Sanford-Orlando Kennel Club in Longwood, Florida from Sanford-Orlando Kennel Club, Inc. and Collins & Collins. Note 5: Acquisitions of this Quarterly Report on Form 10-Q provides further detail regarding the Sanford-Orlando Kennel Club acquisition.

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

**Our Operations**



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We are a leading, diversified, multi-jurisdictional owner and operator of gaming and pari-mutuel properties. We currently own or operate nineteen facilities in fifteen jurisdictions, including Colorado, Florida, Illinois, Indiana, Iowa, Louisiana, Maine, Mississippi, Missouri, New Jersey, New Mexico, Ohio, Pennsylvania, West Virginia and Ontario. We believe that our portfolio of assets provides us with a diversified cash flow from operations.

We have made significant acquisitions in the past five years, and expect to continue to pursue additional acquisition and development opportunities in the future. On March 3, 2003, we acquired Hollywood Casino Corporation, which significantly increased our revenues and cash flow. On February 12, 2004, we purchased Bangor Historic Track, Inc., in Bangor, Maine. On October 3, 2005, we completed our largest acquisition to date, acquiring Argosy Gaming Company ( Argosy ). In early November 2005, we opened a temporary gaming facility in Bangor, Maine. On July 5, 2004, Pennsylvania Governor Edward G. Rendell signed into law the Pennsylvania Race Horse Development and Gaming Act. We are developing a completely new gaming and racing facility at our Penn National Race Course in Grantville, Pennsylvania, which we expect to open with 2,000 slot machines during the first quarter of 2008 at an estimated cost of \$310 million, inclusive of the \$50 million gaming license fee, with the ability to add 1,000 machines as soon as demand warrants. We have a master plan to accommodate up to 5,000 gaming devices, based on demand. In late December 2006, the Pennsylvania Gaming Control Board (the PGCB ) granted us a Category 1 slot machine license for the placement of slot machines at our planned Hollywood Casino at Penn National Race Course. On April 16, 2007, we completed the acquisition of the Black Gold Casino and Zia Park Racetrack, located in Hobbs, New Mexico. On September 11, 2007, we announced that we had executed a definitive agreement to purchase Rosecroft Raceway in Fort Washington, Maryland from Cloverleaf Enterprises, Inc. Pursuant to regulatory approvals received on October 23, 2007, the transaction is expected to close on November 30, 2007. On October 17, 2007, we announced that, following the approval by Florida's Department of Business and Professional Regulation, we had completed our purchase of the Sanford-Orlando Kennel Club in Longwood, Florida from Sanford-Orlando Kennel Club, Inc. and Collins & Collins. In connection with the purchase agreement, we also secured a right of first refusal with respect to a majority stake in the Sarasota Kennel Club in Sarasota, Florida from Jack G. Collins, Sr. and members of his family.

On June 15, 2007, we, along with PNG Acquisition Company Inc. ( Parent ) and PNG Merger Sub Inc., a wholly-owned subsidiary of Parent ( Merger Sub ), announced that we entered into an Agreement and Plan of Merger, dated as of June 15, 2007 (the Merger Agreement ), that provides, among other things, for Merger Sub to be merged with and into us (the Merger ), as a result of which we will continue as the surviving corporation and a wholly-owned subsidiary of Parent. Parent is owned by certain funds managed by affiliates of Fortress Investment Group LLC ( Fortress ) and Centerbridge Partners, L.P. ( Centerbridge ). Pursuant to the Merger Agreement, at the effective time of the Merger, each outstanding share of our common stock (the Common Stock ), other than shares held by us as treasury stock or owned directly or indirectly by Parent or Merger Sub, will be cancelled and converted into the right to receive \$67.00 in cash, without interest. In the event that the Merger shall not have occurred by June 15, 2008 (the Adjustment Date ), the \$67.00 cash amount per share of Common Stock shall be increased for each day after the Adjustment Date, through and including the closing date, by adding an amount equal to \$0.0149 per day.

The vast majority of our revenues is gaming revenue, derived primarily from gaming on slot machines and, to a lesser extent, table games. Other revenues are derived from our management service fee from Casino Rama, our hotel, dining, retail, admissions, program sales, concessions and certain other ancillary activities, and our racing operations. Our racing revenue is derived from wagering on our live races, wagering on import simulcasts at our racetracks and off-track wagering facilities ( OTWs ) and through account wagering, and fees from wagering on export simulcasting of our races.

We intend to continue to expand our gaming operations through the implementation of a disciplined capital expenditure program at our existing properties and the continued pursuit of strategic acquisitions of gaming properties, particularly in attractive regional markets.

Key performance indicators related to revenues are:

Gaming revenue indicators slot handle (volume indicator), table game drop (volume indicator) and win or hold percentages. Our typical property slot win percentage is in the range of 6% to 10% of slot handle and our typical table game win percentage is in the range of 15% to 25% of table game drop; and



Racing revenue indicators pari-mutuel wagering commissions (volume indicator) earned on wagering on our live races, wagering on import simulcasts at our racetracks and OTWs and through account wagering, and fees from wagering on export simulcasting of our races at out-of-state locations.

Our properties generate significant operating cash flow, since most of our revenue is cash-based from slot machines and pari-mutuel wagering. Our business is capital intensive, and we rely on cash flow from our properties to generate operating cash to repay debt, fund capital maintenance expenditures, fund new capital projects at existing properties and provide excess cash for future development and acquisitions.

### **Executive Summary**

Factors affecting our results for the three months ended September 30, 2007, as compared to the three months ended September 30, 2006, included revenue growth at several of our properties, the reopening of Hollywood Casino Bay St. Louis, the first full quarter contribution from Black Gold Casino and Zia Park Racetrack, and lower insurance costs. These increases were partially offset by decreases in gaming revenue at Empress Casino Hotel and Boomtown Biloxi due to competitive pressure, costs related to our support of local referenda in Kansas and West Virginia, and costs associated with our previously announced Merger with certain funds managed by affiliates of Fortress and Centerbridge.

#### *Recent Highlights:*

Net revenues increased \$43.3 million, or 7.4%, for the three months ended September 30, 2007, as compared to the three months ended September 30, 2006, primarily due to revenue growth at several of our properties, including the Charles Town Entertainment Complex, Argosy Casino Lawrenceburg, Argosy Casino Riverside, and Hollywood Casino Aurora, a contribution from Hollywood Casino Bay St. Louis, which was closed from August 28, 2005 until August 31, 2006 due to hurricane damage, and the first full quarter contribution from Black Gold Casino and Zia Park Racetrack, which we acquired in mid-April 2007, all of which was partially offset by decreases at Empress Casino Hotel and Boomtown Biloxi due to competitive pressure.

Income from continuing operations increased by \$5.8 million, or 4.5%, for the three months ended September 30, 2007, as compared to the three months ended September 30, 2006.

On November 7, 2007, we announced that we have established a November 7, 2007 record date and a meeting date of December 12, 2007 for a special meeting at which our shareholders will be asked to consider and vote upon a proposal to approve and adopt the Merger Agreement.

On October 17, 2007, we announced that, following the approval by Florida's Department of Business and Professional Regulation, we had completed our purchase of the Sanford-Orlando Kennel Club in Longwood, Florida

from Sanford-Orlando Kennel Club, Inc. and Collins & Collins. In connection with the purchase agreement, we also secured a right of first refusal with respect to a majority stake in the Sarasota Kennel Club in Sarasota, Florida from Jack G. Collins, Sr. and members of his family. We had originally announced our entry into a definitive agreement to purchase the Sanford-Orlando Kennel Club on July 5, 2007. The purchase price for the Sanford-Orlando Kennel Club contemplated additional consideration to be paid by us based upon certain future regulatory developments. Located on approximately 26 acres in Longwood, Florida, the Sanford-Orlando Kennel Club features year-round greyhound racing, a simulcast wagering facility, a clubhouse lounge and two dining areas.

On September 11, 2007, we announced that we had executed a definitive agreement to purchase Rosecroft Raceway in Fort Washington, Maryland from Cloverleaf Enterprises, Inc. Pursuant to regulatory approvals received on October 23, 2007, the transaction is expected to close on November 30, 2007. Rosecroft Raceway is a harness racing facility located on 130 acres that runs 88 days of live standardbred racing a year and features a simulcast wagering facility, a clubhouse lounge and a dining area overlooking the live action on the racetrack.

On August 30, 2007, we filed a license application with the Kansas Lottery Commission to be considered as a Lottery Gaming Facility Manager at a destination casino resort in Cherokee County, which is budgeted at \$295 million. Cherokee County is within the Southeast Gaming Zone, one of four areas of the state where casino gaming is authorized under the new Kansas Expanded Lottery Act. We previously earned an exclusive endorsement from the Cherokee County Commissioners and executed a pre-development agreement with our host community. On August 23, 2007 an action was filed by the Kansas Attorney General testing the constitutionality of the Kansas Expanded Lottery Act. The challenge is based on the prohibition in the Kansas constitution of all lotteries except those owned by the State of Kansas.

*Other Developments:*

In June 2007, we renewed our first layer of property insurance coverage in the amount of \$200 million. The \$200 million coverage, which is effective from August 8, 2007 through December 31, 2010, is on an all risk basis, including, but not limited to, coverage for named windstorms, floods and earthquakes. Also, we purchased an additional \$400 million of all risk coverage that is subject to certain exclusions including, among others, exclusions for named windstorms, floods and earthquakes. The additional \$400 million coverage is effective from August 8, 2007 through June 1, 2008. There is a \$25 million deductible for named windstorm events, and lesser deductibles as they apply to other perils. Both layers are subject to specific policy terms, conditions and exclusions. The premium for this coverage was \$1.3 million lower during the three months ended September 30, 2007, as compared to the three months ended September 30, 2006. The premium for the new property insurance coverage is expected to be \$8.2 million less, from August 8, 2007 until August 7, 2008, than it was from August 8, 2006 until August 7, 2007.

On June 15, 2007, we, along with PNG Acquisition Company Inc. ( Parent ) and PNG Merger Sub Inc., a wholly-owned subsidiary of Parent ( Merger Sub ), announced that we entered into an Agreement and Plan of Merger, dated as of June 15, 2007 (the Merger Agreement ), that provides, among other things, for Merger Sub to be merged with and into us (the Merger ), as a result of which we will continue as the surviving corporation and a wholly-owned subsidiary of Parent. Parent is owned by certain funds managed by affiliates of Fortress and Centerbridge. Additional information regarding the Merger is discussed in detail in the section entitled Our Operations above.

On June 9, 2007, citizens in Jefferson County, West Virginia, voted against the approval for the placement of table games at the Charles Town Entertainment Complex. According to the West Virginia Lottery Racetrack Table Games Act, the Charles Town Entertainment Complex will have to wait at least two years before it can propose another table game referendum vote.

On June 6, 2007, we announced that our shareholders approved our Annual Incentive Plan and the performance goals thereunder, and voted against the 2007 Employee Long Term Incentive Compensation Plan and the 2007 Long Term Incentive Compensation Plan for Non-Employee Directors of the Company (the 2007 Equity Compensation Plans ). Accordingly, we also announced that we would not proceed with our previously announced program to repurchase up to \$200 million of our common stock, as it was conditioned on shareholder approval of the 2007 Equity Compensation Plans.

On April 16, 2007, pursuant to the Asset Purchase Agreement dated November 7, 2006 among Zia Partners, LLC ( Zia ), Zia Park LLC (the Buyer ), one of our wholly-owned subsidiaries, and (solely with respect to specified sections thereof which relate to our guarantee of the Buyer's payment and performance) us, the Buyer completed the acquisition of the Black Gold Casino and Zia Park Racetrack and all related assets of Zia. We funded this purchase with additional borrowings under our existing \$750 million revolving credit facility.

On March 23, 2007, BTN, Inc. ( "BTN" ), one of our wholly-owned subsidiaries, entered into an amended and restated ground lease (the "Amended Lease" ) with Skrmetta MS, LLC. The lease amended the prior ground lease, dated October 19, 1993. The Amended Lease requires BTN to maintain a minimum gaming operation on the leased premises and to pay rent equal to 5% of adjusted gaming win after gaming taxes have been deducted. The term of the Amended Lease expires on January 1, 2093. The lessor has purchased property owned by BTN and certain other of our wholly-owned subsidiaries in the vicinity of Boomtown Biloxi casino for \$12.8 million. As a result of the execution of the Amended Lease, all litigation between the lessor and BTN has been settled and dismissed.

On January 22, 2007, we completed a claim settlement agreement (the "Claim Settlement Agreement" ) with Allianz Global Risks US Insurance Company, Arch Insurance Company, Everest Reinsurance (Bermuda) Ltd., Princeton Excess and Surplus Lines Insurance Company, U.S. Fire Insurance Company, XL Insurance Company Ltd., HCC International Insurance Co. PLC (Houston Casualty) and certain underwriters at Lloyd's (together, the "Insurers" ) with respect to the business interruption and property damage claims under our all-risk property insurance program resulting from Hurricane Katrina's impact on our Hollywood Casino Bay St. Louis and Boomtown Biloxi properties (the "Hurricane Katrina Claims" ). Pursuant to the Claim Settlement Agreement, which had an effective date of December 31, 2006, the Insurers paid us an aggregate of \$100 million in January 2007, which was in addition to the \$125 million in reimbursements that we previously received from the

Insurers in connection with the Hurricane Katrina Claims, and both we and the Insurers agreed to release each other from, and covenanted not to sue each other regarding, any other claims arising from the Hurricane Katrina catastrophe.

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 our Empress Casino Hotel and Hollywood Casino Aurora, for a 3% tax surcharge to subsidize local horse racing interests. We began paying this tax surcharge during the three months ended June 30, 2006, and have subsequently expensed approximately \$21.1 million in incremental tax, including \$3.8 million in the three months ended September 30, 2007. On May 30, 2006, Empress Casino Hotel and Hollywood Casino Aurora joined with the two other riverboats affected by the law, 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 of Illinois agreed to the entry of an order that established a protest fund for all of the tax surcharge payments and enjoined the Treasurer from making any payments out of that fund pending the final outcome of the litigation. The accumulated funds, including interest accrued during the pendency of the lawsuit, will be returned to the casinos if they ultimately prevail in the lawsuit. In two orders dated March 29, 2007 and April 20, 2007, the Court declared the law unconstitutional under the Uniformity Clause of the Illinois Constitution and enjoined the collection of this tax surcharge. The State of Illinois requested, and was granted, a stay of this ruling. As a result, the casinos will continue paying the 3% tax surcharge into the protest fund until a final order has been entered in the case. The State of Illinois has appealed the ruling to the Illinois Supreme Court. We anticipate that the appeal will take several months before a final ruling is reached on this matter.

We opened Argosy Casino Riverside's Mediterranean-themed, nine-story, 258-room hotel and spa to the public in April 2007, as well as our latest expansion at the Charles Town Entertainment Complex. We are continuing to build and develop several of our properties, including the Charles Town Entertainment Complex, Argosy Casino Lawrenceburg, Hollywood Casino at Penn National Race Course and the permanent Hollywood Slots at Bangor, which will be called the Hollywood Slots Hotel and Raceway. All of our development and expansion projects remain on track with our previously disclosed timetables and budgets, except for the gaming floor space expansion at the Charles Town Entertainment Complex, which was postponed following the June 9, 2007 vote in West Virginia. Additional information regarding our capital projects is discussed in detail in the section entitled "Liquidity and Capital Resources - Capital Expenditures" below.

#### **Critical Accounting Policies**



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We make certain judgments and use certain estimates and assumptions when applying accounting principles in the preparation of our consolidated financial statements. The nature of the estimates and assumptions are material due to the levels of subjectivity and judgment necessary to account for highly uncertain factors or the susceptibility of such factors to change. We have identified the policies related to the accounting for long-lived assets, goodwill and other intangible assets, income taxes and litigation, claims and assessments as critical accounting policies, which require us to make significant judgments, estimates and assumptions.

We believe the current assumptions and other considerations used to estimate amounts reflected in our consolidated financial statements are appropriate. However, if actual experience differs from the assumptions and other considerations used in estimating amounts reflected in our consolidated financial statements, the resulting changes could have a material adverse effect on our consolidated results of operations and, in certain situations, could have a material adverse effect on our financial condition.

The development and selection of the critical accounting policies, and the related disclosures, have been reviewed with the Audit Committee of our Board of Directors.

*Long-lived assets*



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At September 30, 2007, we had a net property and equipment balance of \$1,554.4 million within the consolidated balance sheet, representing 32% of total assets. We depreciate property and equipment on a straight-line basis over their estimated useful lives. The estimated useful lives are determined based on the nature of the assets as well as our current operating strategy. We review the carrying value of our property and equipment for possible impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable based on undiscounted estimated future cash flows expected to result from its use and eventual disposition. The factors considered by us in performing this assessment include current operating results, trends and prospects, as well as the effect of obsolescence, demand, competition

and other economic factors. In estimating expected future cash flows for determining whether an asset is impaired, assets are grouped at the individual property level. In assessing the recoverability of the carrying value of property and equipment, we must make assumptions regarding future cash flows and other factors. If these estimates or the related assumptions change in the future, we may be required to record an impairment loss for these assets. Such an impairment loss would be calculated based upon the discounted future cash flows expected to result from the use of the asset, and would be recognized as a non-cash component of operating income.

*Goodwill and other intangible assets*



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At September 30, 2007, we had \$2,010.7 million in goodwill and \$776.2 million in other intangible assets within the consolidated balance sheet, representing 42% and 16% of total assets, respectively, resulting from our acquisition of other businesses. Two issues arise with respect to these assets that require significant management estimates and judgment: (i) the valuation in connection with the initial purchase price allocation; and (ii) the ongoing evaluation for impairment.

In connection with our acquisitions, valuations are completed to determine the allocation of the purchase prices. The factors considered in the valuations include data gathered as a result of our due diligence in connection with the acquisitions and projections for future operations. Goodwill is tested at least annually for impairment by comparing the fair value of the recorded assets to their carrying amount. If the carrying amount of the goodwill exceeds its fair value, an impairment loss is recognized. In accordance with Statement of Financial Accounting Standards ( SFAS ) No. 142, Goodwill and Other Intangible Assets ( SFAS 142 ), we consider our gaming license and trademark intangible assets as indefinite-life intangible assets that do not require amortization. Rather, these intangible assets are tested at least annually for impairment by comparing the fair value of the recorded assets to their carrying amount. If the carrying amounts of the gaming license and trademark intangible assets exceed their fair value, an impairment loss is recognized. The annual evaluation of goodwill and indefinite-life intangible assets requires the use of estimates about future operating results of each reporting unit to determine their estimated fair value. Changes in forecasted operations can materially affect these estimates. Once an impairment of goodwill or other indefinite-life intangible assets has been recorded, it cannot be reversed. Because our goodwill and indefinite-life intangible assets are not amortized, there may be volatility in reported income because impairment losses, if any, are likely to occur irregularly and in varying amounts. Intangible assets that have a definite-life, including the management service contract for Casino Rama, are amortized on a straight-line basis over their estimated useful lives or related service contract. We review the carrying value of our intangible assets that have a definite-life for possible impairment whenever events or changes in circumstances indicate that their carrying value may not be recoverable. If the carrying amount of the intangible assets that have a definite-life exceed their fair value, an impairment loss is recognized.

### *Income taxes*



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We account for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes* ( SFAS 109 ). Under SFAS 109, deferred tax assets and liabilities are determined based on the differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities and are measured at the prevailing enacted tax rates that will be in effect when these differences are settled or realized. SFAS 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax assets will not be realized.

The realizability of the deferred tax assets is evaluated quarterly by assessing the valuation allowance and by adjusting the amount of the allowance, if necessary. The factors used to assess the likelihood of realization are the forecast of future taxable income and available tax planning strategies that could be implemented to realize the net deferred tax assets. We have used tax-planning strategies to realize or renew net deferred tax assets in order to avoid the potential loss of future tax benefits.

We adopted the provisions of Financial Accounting Standards Board ( FASB ) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ( FIN 48 ) on January 1, 2007. FIN 48 created a single model to address uncertainty in tax positions, and clarified 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 provided guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition.

As a result of the implementation of FIN 48, we recognized a liability for unrecognized tax benefits of approximately \$11.9 million, which was accounted for as a reduction to the January 1, 2007 retained earnings balance. The liability for unrecognized tax benefits is included in noncurrent tax liabilities within the consolidated balance sheet at September 30, 2007.

In addition, we operate within multiple taxing jurisdictions and are subject to audit in each jurisdiction. These audits can involve complex issues that may require an extended period of time to resolve. In our opinion, adequate provisions for income taxes have been made for all periods.

*Litigation, claims and assessments*



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We utilize estimates for litigation, claims and assessments. These estimates are based on our knowledge and experience regarding current and past events, as well as assumptions about future events. If our assessment of such a matter should change, we may have to change the estimate, which may have an adverse effect on our results of operations. Actual results could differ from these estimates.

### Results of Operations

The following are the most important factors and trends that contribute to our operating performance:

The fact that most of our properties operate in mature competitive markets. As a result, we expect a majority of our future growth to come from prudent acquisitions of gaming properties, jurisdictional expansions (such as in Pennsylvania, Maine and Kansas) and property expansion in under-penetrated markets (such as at our Charles Town and Lawrenceburg properties).

The actions of government bodies can affect our operations in a variety of ways. For instance, the continued pressure on governments to balance their budgets could intensify the efforts of state and local governments to raise revenues through increases in gaming taxes. In addition, government bodies may restrict, prevent or negatively impact operations in the jurisdictions in which we do business (such as through the smoking ban in Illinois that was signed in July 2007 and becomes effective on January 1, 2008).

The fact that a number of states are currently considering or implementing legislation to legalize or expand gaming. Such legislation presents both potential opportunities to establish new properties (for instance, in Maryland, Kansas and Ohio) and potential competitive threats to business at our existing properties (such as Kansas, Maryland, Ohio, and Kentucky). The timing and occurrence of these events remain uncertain. We also face uncertainty regarding potential gaming expansion by one of our competitors in Baton Rouge, Louisiana. Legalized gaming from casinos located on Native American lands can also have a significant competitive effect.

The continued demand for, and our emphasis on, slot wagering entertainment at our properties.

The ongoing successful expansion and revenue gains at the Charles Town Entertainment Complex, Argosy Casino Lawrenceburg, Hollywood Casino at Penn National Race Course and Hollywood Slots at Bangor.

The successful execution of the development and construction activities currently underway at a number of our facilities, as well as the risks associated with the costs, regulatory approval and the timing for these activities.



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The results of continuing operations for the three and nine months ended September 30, 2007 and 2006 are summarized below:

| Three Months Ended September 30,  | 2007       | (in thousands) | 2006       |
|-----------------------------------|------------|----------------|------------|
| Revenues:                         |            |                |            |
| Gaming                            | \$ 574,717 |                | \$ 536,901 |
| Management service fee            | 5,217      |                | 4,819      |
| Food, beverage and other          | 82,418     |                | 72,273     |
| Gross revenues                    | 662,352    |                | 613,993    |
| Less promotional allowances       | (32,902)   |                | (27,882)   |
| Net revenues                      | 629,450    |                | 586,111    |
| Operating expenses:               |            |                |            |
| Gaming                            | 296,919    |                | 277,747    |
| Food, beverage and other          | 62,476     |                | 58,064     |
| General and administrative        | 98,935     |                | 91,049     |
| Depreciation and amortization     | 37,241     |                | 31,196     |
| Total operating expenses          | 495,571    |                | 458,056    |
| Income from continuing operations | \$ 133,879 |                | \$ 128,055 |

| Nine Months Ended September 30,   | 2007         | (in thousands) | 2006         |
|-----------------------------------|--------------|----------------|--------------|
| Revenues:                         |              |                |              |
| Gaming                            | \$ 1,694,091 |                | \$ 1,531,155 |
| Management service fee            | 13,032       |                | 14,127       |
| Food, beverage and other          | 239,082      |                | 204,460      |
| Gross revenues                    | 1,946,205    |                | 1,749,742    |
| Less promotional allowances       | (95,253)     |                | (78,056)     |
| Net revenues                      | 1,850,952    |                | 1,671,686    |
| Operating expenses:               |              |                |              |
| Gaming                            | 878,296      |                | 787,970      |
| Food, beverage and other          | 183,929      |                | 166,716      |
| General and administrative        | 291,427      |                | 249,565      |
| Depreciation and amortization     | 110,221      |                | 88,642       |
| Total operating expenses          | 1,463,873    |                | 1,292,893    |
| Income from continuing operations | \$ 387,079   |                | \$ 378,793   |

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The results of continuing operations by property for the three and nine months ended September 30, 2007 and 2006 are summarized below:

| Three Months Ended September 30,        | Net Revenues      |                   | Income (loss) from Continuing Operations |                   |
|-----------------------------------------|-------------------|-------------------|------------------------------------------|-------------------|
|                                         | 2007              | 2006              | 2007                                     | 2006              |
|                                         | (in thousands)    |                   |                                          |                   |
| Charles Town Entertainment Complex      | \$ 133,376        | \$ 126,973        | \$ 34,229                                | \$ 31,917         |
| Argosy Casino Lawrenceburg              | 121,777           | 120,206           | 37,070                                   | 35,599            |
| Hollywood Casino Aurora                 | 63,755            | 61,781            | 19,330                                   | 16,680            |
| Empress Casino Hotel                    | 55,926            | 59,852            | 8,100                                    | 10,768            |
| Argosy Casino Riverside                 | 44,999            | 37,999            | 11,050                                   | 8,451             |
| Hollywood Casino Baton Rouge            | 34,201            | 33,333            | 11,695                                   | 11,564            |
| Argosy Casino Alton                     | 30,050            | 29,090            | 9,559                                    | 5,573             |
| Hollywood Casino Tunica                 | 26,380            | 27,089            | 5,429                                    | 4,785             |
| Hollywood Casino Bay St. Louis          | 24,545            | 10,767            | 1,407                                    | 2,163             |
| Argosy Casino Sioux City                | 13,504            | 13,319            | 3,285                                    | 3,133             |
| Boomtown Biloxi                         | 20,861            | 27,927            | 2,417                                    | 10,959            |
| Hollywood Slots at Bangor               | 12,674            | 11,187            | 2,870                                    | 2,130             |
| Bullwhackers                            | 7,886             | 6,903             | 245                                      | 350               |
| Zia Park (1)                            | 20,367            |                   | 6,096                                    |                   |
| Casino Rama management service contract | 5,217             | 4,819             | 4,811                                    | 4,466             |
| Pennsylvania Racing Operations          | 11,815            | 12,691            | (1,419)                                  | 439               |
| Raceway Park                            | 2,117             | 2,175             | (415)                                    | (190)             |
| Corporate overhead                      |                   |                   | (21,880)                                 | (20,732)          |
| <b>Total</b>                            | <b>\$ 629,450</b> | <b>\$ 586,111</b> | <b>\$ 133,879</b>                        | <b>\$ 128,055</b> |

| Nine Months Ended September 30,         | Net Revenues        |                     | Income (loss) from Continuing Operations |                   |
|-----------------------------------------|---------------------|---------------------|------------------------------------------|-------------------|
|                                         | 2007                | 2006                | 2007                                     | 2006              |
|                                         | (in thousands)      |                     |                                          |                   |
| Charles Town Entertainment Complex      | \$ 382,112          | \$ 366,343          | \$ 96,247                                | \$ 92,301         |
| Argosy Casino Lawrenceburg              | 364,871             | 355,363             | 111,033                                  | 105,469           |
| Hollywood Casino Aurora                 | 192,307             | 184,234             | 56,071                                   | 53,924            |
| Empress Casino Hotel                    | 174,032             | 179,904             | 29,784                                   | 38,645            |
| Argosy Casino Riverside                 | 129,831             | 114,601             | 31,445                                   | 28,371            |
| Hollywood Casino Baton Rouge            | 103,123             | 111,900             | 36,446                                   | 43,136            |
| Argosy Casino Alton                     | 91,279              | 86,814              | 22,853                                   | 16,478            |
| Hollywood Casino Tunica                 | 79,351              | 82,146              | 14,796                                   | 15,814            |
| Hollywood Casino Bay St. Louis          | 73,495              | 10,767              | 4,670                                    | 1,789             |
| Argosy Casino Sioux City                | 41,456              | 40,566              | 10,363                                   | 10,121            |
| Boomtown Biloxi                         | 67,599              | 28,937              | 12,545                                   | 11,221            |
| Hollywood Slots at Bangor               | 35,635              | 30,001              | 7,484                                    | 5,260             |
| Bullwhackers                            | 22,500              | 20,525              | 829                                      | 842               |
| Zia Park (1)                            | 37,280              |                     | 11,556                                   |                   |
| Casino Rama management service contract | 13,032              | 14,127              | 11,983                                   | 13,098            |
| Pennsylvania Racing Operations          | 37,199              | 38,851              | (3,891)                                  | 1,288             |
| Raceway Park                            | 5,850               | 6,607               | (936)                                    | (369)             |
| Corporate overhead                      |                     |                     | (66,199)                                 | (58,595)          |
| <b>Total</b>                            | <b>\$ 1,850,952</b> | <b>\$ 1,671,686</b> | <b>\$ 387,079</b>                        | <b>\$ 378,793</b> |

(1) Reflects results since the April 16, 2007 acquisition effective date.



### Revenues

Revenues for the three and nine months ended September 30, 2007 and 2006 are as follows:

| Three Months Ended September 30, | 2007           | 2006       | Variance  | Percentage<br>Variance |
|----------------------------------|----------------|------------|-----------|------------------------|
|                                  | (in thousands) |            |           |                        |
| Gaming                           | \$ 574,717     | \$ 536,901 | \$ 37,816 | 7.0%                   |
| Management service fee           | 5,217          | 4,819      | 398       | 8.3%                   |
| Food, beverage and other         | 82,418         | 72,273     | 10,145    | 14.0%                  |
| Gross revenue                    | 662,352        | 613,993    | 48,359    | 7.9%                   |
| Less promotional allowances      | (32,902)       | (27,882)   | (5,020)   | (18.0)%                |
| Net revenues                     | \$ 629,450     | \$ 586,111 | \$ 43,339 | 7.4%                   |

| Nine Months Ended September 30, | 2007           | 2006         | Variance   | Percentage<br>Variance |
|---------------------------------|----------------|--------------|------------|------------------------|
|                                 | (in thousands) |              |            |                        |
| Gaming                          | \$ 1,694,091   | \$ 1,531,155 | \$ 162,936 | 10.6%                  |
| Management service fee          | 13,032         | 14,127       | (1,095)    | (7.8)%                 |
| Food, beverage and other        | 239,082        | 204,460      | 34,622     | 16.9%                  |
| Gross revenue                   | 1,946,205      | 1,749,742    | 196,463    | 11.2%                  |
| Less promotional allowances     | (95,253)       | (78,056)     | (17,197)   | (22.0)%                |
| Net revenues                    | \$ 1,850,952   | \$ 1,671,686 | \$ 179,266 | 10.7%                  |

### *Gaming revenue*

Gaming revenue increased by \$37.8 million, or 7.0%, and \$162.9 million, or 10.6%, for the three and nine months ended September 30, 2007, respectively, as compared to the same periods in 2006, primarily due to revenue growth at several of our properties, including the Charles Town Entertainment Complex, Argosy Casino Lawrenceburg, Argosy Casino Riverside, and Hollywood Casino Aurora, the reopening of Hollywood Casino Bay St. Louis, and the first full quarter contribution from Black Gold Casino and Zia Park Racetrack. The increase in gaming revenue for the three months ended September 30, 2007 was partially offset by decreases in gaming revenue at Empress Casino Hotel and Boomtown Biloxi. The increase in gaming revenue for the nine months ended September 30, 2007 was also due to the reopening of Boomtown Biloxi and continued growth at the Hollywood Slots at Bangor, offset by a decrease in gaming revenue at Empress Casino Hotel and Hollywood Casino Baton Rouge.

Gaming revenue at the Charles Town Entertainment Complex increased by \$6.0 million and \$14.4 million for the three and nine months ended September 30, 2007, respectively, primarily due to an increase in gaming play as a result of slot expansion and an aggressive advertising and promotional campaign.

Gaming revenue at Argosy Casino Lawrenceburg increased by \$1.6 million and \$9.2 million for the three and nine months ended September 30, 2007, respectively. The increases were primarily due to increases in slot and poker room revenues and decreases in sales incentives and point loyalty programs, all of which were partially offset by a decrease in table game revenue. Slot revenue benefited from the expansion of highly popular low denomination video slot machines, which generate a higher win per unit and hold percentages than other slot machines. The increase in gaming revenue for the nine months ended September 30, 2007 was also due to an increase in poker revenue, as the poker room was

not in operation in the first quarter of 2006.

Gaming revenue at Argosy Casino Riverside increased by \$5.2 million and \$12.1 million for the three and nine months ended September 30, 2007, respectively, primarily due to successful marketing promotions and increased traffic on the property due to the new hotel that opened in April 2007.

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Gaming revenue at Hollywood Casino Aurora increased by \$2.0 million and \$7.9 million for the three and nine months ended September 30, 2007, respectively. The increases were primarily due to increases in slot and table game revenues resulting from the continued refinement of marketing programs and the incentives offered to existing customers, as well as increases in slot hold. The increase in gaming revenue for the three months ended September 30, 2007 was partially offset by a decrease in slot handle, which we believe to be due to higher summer gas prices and the weakened credit market. The increase in gaming revenue for the nine months ended September 30, 2007 was also due to increases in slot handle and poker revenue. For both the three and nine months ended September 30, 2007, slot revenue benefited from the expansion of highly popular low denomination video slot machines, which generate a higher win per unit and hold percentages than other slot machines.

Gaming revenue at Hollywood Casino Bay St. Louis increased by \$11.9 million and \$55.7 million for the three and nine months ended September 30, 2007, respectively, as the property was closed from August 28, 2005 until August 31, 2006 due to hurricane damage.

Gaming revenue at Black Gold Casino and Zia Park Racetrack, which we acquired in mid-April 2007, was \$18.8 million and \$34.7 million for the three and nine months ended September 30, 2007, respectively.

Gaming revenue at Empress Casino Hotel decreased by \$4.0 million and \$5.7 million for the three and nine months ended September 30, 2007, respectively, due to competitive pressure.

Gaming revenue at Boomtown Biloxi decreased by \$7.0 million for the three months ended September 30, 2007, due to competitive pressure and the ongoing post-hurricane market stabilization. Gaming revenue at Boomtown Biloxi increased by \$35.7 million for the nine months ended September 30, 2007, as the property was closed from August 28, 2005 until June 29, 2006 due to hurricane damage.

Gaming revenue at Hollywood Slots at Bangor increased by \$5.5 million for the nine months ended September 30, 2007, due to continued growth in the Bangor market.

Gaming revenue at Hollywood Casino Baton Rouge decreased by \$9.0 million for the nine months ended September 30, 2007 due to ongoing post-hurricane market stabilization.

### *Food, beverage and other revenue*

Food, beverage and other revenue increased by \$10.1 million, or 14.0%, and \$34.6 million, or 16.9%, for the three and nine months ended September 30, 2007, respectively, as compared to the same periods in 2006, primarily due to the reopening of Hollywood Casino Bay St. Louis, the opening of the Argosy Casino Riverside hotel, and the first full quarter contribution from Black Gold Casino and Zia Park Racetrack. The increase in food, beverage and other revenue for the nine months ended September 30, 2007 was also due to the reopening of Boomtown Biloxi.

Food, beverage and other revenue at Hollywood Casino Bay St. Louis increased by \$5.2 million and \$18.0 million for the three and nine months ended September 30, 2007, respectively, as the property was closed from August 28, 2005 until August 31, 2006 due to hurricane damage.

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Food, beverage and other revenue at Argosy Casino Riverside increased by \$2.6 million and \$4.8 million for the three and nine months ended September 30, 2007, respectively, primarily due to the opening of its hotel to the public in April 2007.

Food, beverage and other revenue at Black Gold Casino and Zia Park Racetrack, which we acquired in mid-April 2007, was \$1.7 million and \$2.8 million for the three and nine months ended September 30, 2007, respectively.

Food, beverage and other revenue at Boomtown Biloxi increased by \$6.7 million for the nine months ended September 30, 2007, as the property was closed from August 28, 2005 until June 29, 2006 due to hurricane damage.

### *Promotional allowances*

Promotional allowances increased by \$5.0 million, or 18.0%, and \$17.2 million, or 22.0%, for the three and nine months ended September 30, 2007, respectively, as compared to the same periods in 2006, primarily due to the reopening of Hollywood Casino Bay St. Louis and Boomtown Biloxi, as well as the opening of the Argosy Casino Riverside hotel.

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Promotional allowances at Hollywood Casino Bay St. Louis increased by \$3.3 million and \$11.1 million for the three and nine months ended September 30, 2007, respectively, as the property was closed from August 28, 2005 until August 31, 2006 due to hurricane damage.

Promotional allowances at Boomtown Biloxi increased by \$0.2 million and \$3.6 million for the three and nine months ended September 30, 2007, respectively, as the property was closed from August 28, 2005 until June 29, 2006 due to hurricane damage.

Promotional allowances at Argosy Casino Riverside increased by \$0.7 million and \$1.7 million for the three and nine months ended September 30, 2007, respectively, primarily due to the opening of its hotel to the public in April 2007 and gaming revenue growth.

### Operating Expenses

Operating expenses for the three and nine months ended September 30, 2007 and 2006 are as follows (in thousands):

| Three Months Ended September 30, | 2007       | 2006       | Variance  | Percentage<br>Variance |
|----------------------------------|------------|------------|-----------|------------------------|
| Gaming                           | \$ 296,919 | \$ 277,747 | \$ 19,172 | 6.9%                   |
| Food, beverage and other         | 62,476     | 58,064     | 4,412     | 7.6%                   |
| General and administrative       | 98,935     | 91,049     | 7,886     | 8.7%                   |
| Depreciation and amortization    | 37,241     | 31,196     | 6,045     | 19.4%                  |
| Total operating expenses         | \$ 495,571 | \$ 458,056 | \$ 37,515 | 8.2%                   |

| Nine Months Ended September 30, | 2007         | 2006         | Variance   | Percentage<br>Variance |
|---------------------------------|--------------|--------------|------------|------------------------|
| Gaming                          | \$ 878,296   | \$ 787,970   | \$ 90,326  | 11.5%                  |
| Food, beverage and other        | 183,929      | 166,716      | 17,213     | 10.3%                  |
| General and administrative      | 291,427      | 249,565      | 41,862     | 16.8%                  |
| Depreciation and amortization   | 110,221      | 88,642       | 21,579     | 24.3%                  |
| Total operating expenses        | \$ 1,463,873 | \$ 1,292,893 | \$ 170,980 | 13.2%                  |

### *Gaming expense*

Gaming expense increased by \$19.2 million, or 6.9%, and \$90.3 million, or 11.5%, for the three and nine months ended September 30, 2007, as compared to the same periods in 2006, primarily due to the reopening of Hollywood Casino Bay St. Louis, the first full quarter contribution from Black Gold Casino and Zia Park Racetrack, and increased gaming taxes and other gaming expenses at several of our properties. The increase in gaming expense for the three months ended September 30, 2007 was partially offset by decreases in gaming expense at Empress Casino Hotel and Argosy Casino Alton. The increase in gaming expense for the nine months ended September 30, 2007 was also due to the reopening of Boomtown Biloxi, offset by a decrease in gaming expense at Argosy Casino Alton.

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Gaming expense at Hollywood Casino Bay St. Louis increased by \$7.6 million and \$31.5 million for the three and nine months ended September 30, 2007, respectively, as the property was closed from August 28, 2005 until August 31, 2006 due to hurricane damage.

Gaming expense at Black Gold Casino and Zia Park Racetrack, which we acquired in mid-April 2007, was \$10.3 million and \$18.9 million, respectively, for the three and nine months ended September 30, 2007.

Gaming expense at the Charles Town Entertainment Complex increased by \$3.9 million and \$8.8 million for the three and nine months ended September 30, 2007, respectively, due to increased gaming taxes and purses resulting from higher gaming revenue.

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Gaming expense at Argosy Casino Riverside increased by \$1.8 million and \$4.0 million for the three and nine months ended September 30, 2007, respectively, due to an increase in gaming taxes resulting from higher gaming revenue.

Gaming expense at Empress Casino Hotel decreased by \$2.3 million for the three months ended September 30, 2007, primarily due to decreases in marketing expenses and gaming taxes. Gaming expense at Empress Casino Hotel increased by \$1.2 million for the nine months ended September 30, 2007, primarily due to payment of the 3% Illinois tax surcharge, which began in May 2006, and an adjustment in the gaming tax effective rate, offset by decreases in marketing and general expenses.

Gaming expense at Hollywood Casino Aurora increased by \$4.7 million for the nine months ended September 30, 2007, due to payment of the 3% Illinois tax surcharge, which began in May 2006.

Gaming expense at Argosy Casino Lawrenceburg increased by \$2.7 million for the nine months ended September 30, 2007, due to an increase in gaming taxes associated with the increase in gaming revenue.

Gaming expense at Hollywood Slots at Bangor increased by \$2.9 million for the nine months ended September 30, 2007, due to an increase in gaming taxes associated with growth in gaming revenue.

Gaming expense at Argosy Casino Alton decreased by \$3.2 million and \$2.5 million for the three and nine months ended September 30, 2007, respectively, due to the expiration of the Illinois hold harmless tax minimum guarantee on July 1, 2007.

Gaming expense at Boomtown Biloxi increased by \$14.6 million for the nine months ended September 30, 2007, as the property was closed from August 28, 2005 until June 29, 2006 due to hurricane damage.

### *Food, beverage and other expense*

Food, beverage and other expense increased by \$4.4 million, or 7.6%, and \$17.2 million, or 10.3%, for the three and nine months ended September 30, 2007, as compared to the same periods in 2006, primarily due to the reopening of Hollywood Casino Bay St. Louis, the opening of the Argosy Casino Riverside hotel, our purchase and opening of a gas station/convenience store near our Bullwhackers facility, and the first full quarter contribution from Black Gold Casino and Zia Park Racetrack. The increase in food, beverage and other expense for the nine months ended September 30, 2007 was also due to the reopening of Boomtown Biloxi.

Food, beverage and other expense at Hollywood Casino Bay St. Louis increased by \$1.2 million and \$5.0 million for the three and nine months ended September 30, 2007, respectively, as the property was closed from August 28, 2005 until August 31, 2006 due to hurricane damage.

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Food, beverage and other expense at Argosy Casino Riverside increased by \$1.8 million and \$4.3 million for the three and nine months ended September 30, 2007, respectively, primarily due to the opening of its hotel to the public in April 2007.

Food, beverage and other expense at Bullwhackers increased by \$0.8 million and \$2.4 million for the three and nine months ended September 30, 2007, respectively, primarily due to our purchase and opening of a gas station/convenience store near our Bullwhackers facility during the third quarter of 2006.

Food, beverage and other expense at Black Gold Casino and Zia Park Racetrack, which we acquired in mid-April 2007, was \$0.9 million and \$1.2 million for the three and nine months ended September 30, 2007, respectively.

Food, beverage and other expense at Boomtown Biloxi increased by \$3.5 million for the nine months ended September 30, 2007, as the property was closed from August 28, 2005 until June 29, 2006 due to hurricane damage.

### *General and administrative expense*

General and administrative expense increased by \$7.9 million, or 8.7%, and \$41.9 million, or 16.8%, for the three and nine months ended September 30, 2007, as compared to the same periods in 2006. General and administrative expense at the properties includes expenses such as compliance, facility maintenance, utilities, property and liability insurance, surveillance and security, and certain housekeeping, as well as all expenses for administrative departments such as accounting, purchasing, human resources, legal and internal audit.

General and administrative expense at Hollywood Casino Bay St. Louis increased by \$3.6 million and \$15.1 million for

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the three and nine months ended September 30, 2007, respectively, as the property was closed from August 28, 2005 until August 31, 2006 due to hurricane damage.

General and administrative expense at Boomtown Biloxi increased by \$1.1 million and \$12.8 million for the three and nine months ended September 30, 2007, respectively, as the property was closed from August 28, 2005 until June 29, 2006 due to hurricane damage.

General and administrative expense at Black Gold Casino and Zia Park Racetrack, which we acquired in mid-April 2007, was \$1.8 million and \$3.3 million for the three and nine months ended September 30, 2007.

Corporate overhead expense increased by \$7.8 for the nine months ended September 30, 2007, primarily due to lobbying costs incurred in support of local referenda in Kansas and West Virginia, as well as the costs incurred relating to the grant of equity-based compensation awards as required under Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment having increased by \$3.9 million, as additional equity-based compensation awards were granted during 2007. We grant a substantial portion of our equity-based compensation awards during the first three months of the year.

### *Depreciation and amortization expense*

Depreciation and amortization expense increased by \$6.0 million, or 19.4%, and \$21.6 million, or 24.3%, for the three and nine months ended September 30, 2007, respectively, as compared to the same periods in 2006, primarily due to incremental depreciation at the Charles Town Entertainment Complex, the reopening of Hollywood Casino Bay St. Louis and Boomtown Biloxi, the opening of the Argosy Casino Riverside hotel, and the first full quarter contribution from Black Gold Casino and Zia Park Racetrack.

Depreciation and amortization expense at the Charles Town Entertainment Complex increased by \$0.4 million and \$3.4 million for the three and nine months ended September 30, 2007, respectively, due to incremental depreciation for assets placed into service subsequent to the same periods in 2006, including expanded gaming space, a 378-seat buffet and a new parking garage, which were completed in mid-2006.

Depreciation and amortization expense at Hollywood Casino Bay St. Louis increased by \$2.2 million and \$8.3 million for the three and nine months ended September 30, 2007, respectively, as the property was closed from August 28, 2005 until August 31, 2006 due to hurricane damage.

Depreciation and amortization expense at Boomtown Biloxi increased by \$1.1 million and \$6.4 million for the three and nine months ended September 30, 2007, respectively, as the property was closed from August 28, 2005 until June 29, 2006 due to hurricane damage.

Depreciation and amortization expense at Argosy Casino Riverside increased by \$0.9 million and \$2.1 million for the three and nine months ended September 30, 2007, respectively, primarily due to the opening of its hotel to the public in April 2007.

Depreciation and amortization expense at Black Gold Casino and Zia Park Racetrack, which we acquired in mid-April 2007, was \$1.2 million and \$2.3 million for the three and nine months ended September 30, 2007, respectively.

Other income (expense)

Other income (expense) for the three and nine months ended September 30, 2007 and 2006 are as follows (in thousands):

| Three Months Ended September 30,   | 2007        | 2006        | Variance | Percentage<br>Variance |
|------------------------------------|-------------|-------------|----------|------------------------|
| Interest expense                   | \$ (50,203) | \$ (49,732) | \$ (471) | (0.9)%                 |
| Interest income                    | 1,020       | 882         | 138      | 15.6%                  |
| Earnings (loss) from joint venture | (122)       | (1,665)     | 1,543    | 92.7%                  |
| Other                              | (2,637)     | (593)       | (2,044)  | (344.7)%               |
| Total other expenses               | \$ (51,942) | \$ (51,108) | \$ (834) | (1.6)%                 |

| Nine Months Ended September 30,      | 2007         | 2006         | Variance   | Percentage<br>Variance |
|--------------------------------------|--------------|--------------|------------|------------------------|
| Interest expense                     | \$ (149,852) | \$ (145,927) | \$ (3,925) | (2.7)%                 |
| Interest income                      | 3,185        | 2,652        | 533        | 20.1%                  |
| Earnings from joint venture          | 243          | (678)        | 921        | 135.8%                 |
| Other                                | (8,341)      | (519)        | (7,822)    | (1,507.1)%             |
| Loss on early extinguishment of debt |              | (10,022)     | 10,022     | 100.0%                 |
| Total other expenses                 | \$ (154,765) | \$ (154,494) | \$ (271)   | (0.2)%                 |

*Interest expense*

Interest expense increased by \$3.9 million, or 2.7%, for the nine months ended September 30, 2007, as compared to the same period in 2006, primarily due to incremental interest related to additional borrowings under our revolving credit facility, the Mohegan Tribal Gaming Authority ( MTGA ) long-term obligation entered into in August 2006, and our insurance financing, all of which were partially offset by an increase in capitalized interest.

*Other*

Other increased by \$2.0 million and \$7.8 million for the three and nine months ended September 30, 2007, respectively, as compared to the same periods in 2006, primarily due to after-tax Merger-related costs and non-cash pre-tax currency translation losses that were recorded during the three and nine months ended September 30, 2007.

*Loss on early extinguishment of debt*

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We recorded a \$10.0 million loss on early extinguishment of debt during the nine months ended September 30, 2006, as a result of the redemption of \$175 million in aggregate principal amount of our outstanding 8<sup>7</sup>/<sub>8</sub>% senior subordinated notes due March 15, 2010. As a result of the redemption, we recorded a loss on early extinguishment of debt of \$10.0 million for the call premium and the write-off of the associated deferred financing fees.

### Taxes

Our effective tax rate decreased to 43.1% for the three months ended September 30, 2007, as compared to 47.5% for the same period in 2006, as the prior year rate included the impact of a discrete item for estimated state tax rates. The increase in our effective tax rate to 45.0% for the nine months ended September 30, 2007, as compared to 44.2% for the same period in 2006, reflects the non-deductibility of permanent differences and our adoption of FIN 48 on January 1, 2007.

### Discontinued operations

On October 15, 2004, we announced the sale of The Downs Racing, Inc. and its subsidiaries to the MTGA. In January 2005, we received \$280 million from the MTGA, and transferred the operations of The Downs Racing, Inc. and its subsidiaries to the MTGA. The sale was not considered final for accounting purposes until the third quarter of 2006, as the MTGA had certain post-closing termination rights that remained outstanding. On August 7, 2006, we entered into the Second Amendment to the Purchase Agreement and Release of Claims ( Amendment and Release ) with the MTGA pertaining to the

October 14, 2004 Purchase Agreement (the "Purchase Agreement"), and agreed to pay the MTGA an aggregate of \$30 million over five years, beginning on the first anniversary of the commencement of slot operations at Mohegan Sun at Pocono Downs, in exchange for the MTGA's agreement to release various claims it raised against us under the Purchase Agreement and the MTGA's surrender of all post-closing termination rights it might have had under the Purchase Agreement. As a result of the Amendment and Release, we recorded, in accordance with United States generally accepted accounting principles, a net book gain on the \$250 million sale (\$280 million initial price, less \$30 million payable pursuant to the Amendment and Release) of The Downs Racing, Inc. and its subsidiaries to the MTGA of \$114.7 million (net of \$84.3 million of income taxes) during the three and nine months ended September 30, 2006. In addition, we recorded the present value of the \$30 million liability within debt, as the amount due to the MTGA is payable over five years, with the first payment to occur in November 2007.

## Liquidity and Capital Resources

Historically, our primary sources of liquidity and capital resources have been cash flow from operations, borrowings from banks and proceeds from the issuance of debt and equity securities.

Net cash provided by operating activities was \$346.1 million and \$217.1 million for the nine months ended September 30, 2007 and 2006, respectively. Net cash provided by operating activities for the nine months ended September 30, 2007 included net income of \$127.8 million, non-cash reconciling items, such as depreciation, amortization, and the charge for stock compensation of \$152.2 million, and net changes in current asset and liability accounts of \$66.1 million, including proceeds of \$100.0 million relating to the collection of insurance receivables.

Net cash used in investing activities totaled \$470.9 million and \$244.4 million for the nine months ended September 30, 2007 and 2006, respectively. Net cash used in investing activities for the nine months ended September 30, 2007 included expenditures for property and equipment totaling \$232.1 million and acquisition of businesses and licenses, such as the Pennsylvania gaming license and Black Gold Casino and Zia Park Racetrack acquisition, totaling \$253.1 million, both of which were partially offset by proceeds from the sale of property and equipment totaling \$14.3 million.

Net cash provided by financing activities totaled \$135.4 million and \$31.0 million for the nine months ended September 30, 2007 and 2006, respectively. Net cash provided by financing activities for the nine months ended September 30, 2007 included proceeds from the exercise of stock options totaling \$21.4 million, proceeds from the issuance of long-term debt of \$327.0 million, proceeds from insurance financing of \$26.0 million and the tax benefit from stock options exercised totaling \$16.9 million, all of which were partially offset by principal payments on long-term debt totaling \$231.8 million and \$24.1 million in payments on insurance financing.

## Capital Expenditures

Capital expenditures are accounted for as either capital project or capital maintenance (replacement) expenditures. Capital project expenditures are for fixed asset additions that expand an existing facility. Capital maintenance (replacement) expenditures are expenditures to replace existing fixed assets with a useful life greater than one year that are obsolete, worn out or no longer cost effective to repair.

The following table summarizes our capital project expenditures by property for the fiscal year ending December 31, 2007, and actual expenditures for the nine months ended September 30, 2007, other than capital maintenance expenditures and Hurricane Katrina-related capital

project expenditures at Boomtown Biloxi and Hollywood Casino Bay St. Louis:

| Property                                         | Expected for Year<br>Ending<br>December 31, 2007 | Expenditures<br>Through<br>September 30, 2007<br>(in millions) | Balance to Expend<br>in 2007 |
|--------------------------------------------------|--------------------------------------------------|----------------------------------------------------------------|------------------------------|
| Charles Town Entertainment Complex               | \$ 36.2                                          | \$ 28.0                                                        | \$ 8.2                       |
| Hollywood Casino at Penn National Race<br>Course | 166.1                                            | 91.1                                                           | 75.0                         |
| Hollywood Slots at Bangor                        | 61.2                                             | 25.5                                                           | 35.7                         |
| Argosy Casino Riverside                          | 10.0                                             | 9.3                                                            | 0.7                          |
| Argosy Casino Lawrenceburg                       | 42.1                                             | 29.4                                                           | 12.7                         |
| Other                                            | 10.8                                             | 5.4                                                            | 5.4                          |
| Total                                            | \$ 326.4                                         | \$ 188.7                                                       | \$ 137.7                     |

At the Charles Town Entertainment Complex, we opened phase one of our latest expansion on April 20, 2007, bringing Charles Town's total slot count to approximately 5,000 units. Our next phase of development at the Charles Town Entertainment Complex includes plans for a 153-room hotel. The expected opening date of the hotel is the third quarter of 2008.

In late December 2006, the PGCB granted us a Category 1 slot machine license for the placement of slot machines at our planned Hollywood Casino at Penn National Race Course. In August 2006, we commenced construction of the integrated racing and gaming facility at Penn National Race Course. The Hollywood Casino at Penn National Race Course will be a 365,000 square foot facility, and will be sized for 2,000 slot machines, with the building size sufficient to add 1,000 additional machines. The Hollywood Casino at Penn National Race Course will also include a 2,500 space parking garage and several restaurants. The expected opening date is during the first quarter of 2008. We plan to spend an aggregate of \$310 million on the project.

At the Hollywood Slots at Bangor, we are building a permanent facility, which will include a 1,500 slot facility (1,000 slot machines at opening), a 152-room hotel, a 1,500 space parking garage and several restaurants. The expected opening date is the third quarter of 2008. We plan to spend an aggregate of \$131 million on the project. Upon completion, the permanent facility will be called the Hollywood Slots Hotel and Raceway.

We opened Argosy Casino Riverside's Mediterranean-themed, nine-story, 258-room hotel and spa to the public in April 2007.

The expansion at Argosy Casino Lawrenceburg includes a 1,500 space parking garage, which is expected to open in the second quarter of 2008, a two-level 270,000 square foot riverboat, and numerous infrastructure upgrades to allow more convenient access to the property, which are expected to open in the second quarter of 2009. The new riverboat will allow up to 4,000 positions on one level and another 400 positions will be added to the second level, along with restaurants and other amenities on the gaming riverboat. We plan to spend an aggregate of \$310 million on the project.

During the nine months ended September 30, 2007, we spent approximately \$2.7 million for Hurricane Katrina-related capital project expenditures at Boomtown Biloxi and Hollywood Casino Bay St. Louis.

During the nine months ended September 30, 2007, we spent approximately \$40.7 million for capital maintenance expenditures at our properties. The majority of the capital maintenance expenditures were for slot machines, slot machine equipment, and environmental work.

Cash generated from operations and cash available under the revolver portion of our \$2.725 billion senior secured credit facility have funded our capital project and capital maintenance expenditures in 2007 to date.

*Debt**Senior Secured Credit Facility*

During the nine months ended September 30, 2007, we borrowed \$327.0 million under our \$2.725 billion senior secured credit facility, and made principal payments on our \$2.725 billion senior secured credit facility of \$230.9 million, for activities arising in the normal course of business.

*Covenants*

Our \$2.725 billion senior secured credit facility, \$200 million 6<sup>7</sup>/<sub>8</sub>% and \$250 million 6<sup>3</sup>/<sub>4</sub>% senior subordinated notes require us, 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, our \$2.725 billion senior secured credit facility, \$200 million 6<sup>7</sup>/<sub>8</sub>% and \$250 million 6<sup>3</sup>/<sub>4</sub>% senior subordinated notes restrict, among other things, our 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 September 30, 2007, we were in compliance with all required covenants.

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

The table below provides information at September 30, 2007 about our financial instruments that are sensitive to changes in interest rates, including debt obligations and interest rate swaps. For debt obligations, the table presents notional amounts maturing during the period and the related weighted-average interest rates at period-end. For interest rate swaps, the table presents notional amounts and weighted-average interest rates outstanding at each period-end. Notional amounts are used to calculate the contractual payments to be exchanged under the contract and the weighted-average variable rates are based on implied forward rates in the yield curve as of September 30, 2007.

|                           | 10/1/07-<br>9/30/08 | 10/1/08-<br>9/30/09 | 10/1/09-<br>9/30/10 | 10/1/10-<br>9/30/11<br>(in thousands) | 10/1/11-<br>9/30/12 | Thereafter | Total        | Fair Value<br>9/30/07 |
|---------------------------|---------------------|---------------------|---------------------|---------------------------------------|---------------------|------------|--------------|-----------------------|
| <b>Long-term debt:</b>    |                     |                     |                     |                                       |                     |            |              |                       |
| Fixed rate                | \$ 5,512            | \$ 5,910            | \$ 5,807            | \$ 5,697                              | \$ 203,460          | \$ 250,000 | \$ 476,386   | \$ 483,886            |
| Average interest rate     | 7.00%               | 7.00%               | 7.00%               | 7.00%                                 | 6.88%               | 6.75%      |              |                       |
| Variable rate             | \$ 81,500           | \$ 97,750           | \$ 97,750           | \$ 587,625                            | \$ 1,187,625        | \$ 387,750 | \$ 2,440,000 | \$ 2,440,000          |
| Average interest rate (1) | 6.38%               | 5.92%               | 6.36%               | 6.54%                                 | 7.02%               | 7.19%      |              |                       |
| Leases                    | \$ 2,175            | \$ 2,098            | \$ 1,204            | \$ 1,039                              | \$ 1,120            | \$ 1,940   | \$ 9,576     | \$                    |
| Average interest rate     | 6.95%               | 6.76%               | 5.88%               | 5.65%                                 | 5.65%               | 7.72%      |              |                       |

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## Interest rate

### derivatives:

#### Interest rate swaps

##### Variable to fixed

|                          |    |           |    |         |    |         |    |  |    |  |     |    |         |
|--------------------------|----|-----------|----|---------|----|---------|----|--|----|--|-----|----|---------|
| (2)                      | \$ | 1,260,000 | \$ | 811,000 | \$ | 574,000 | \$ |  | \$ |  | N/A | \$ | (7,904) |
| Average pay rate         |    | 4.84%     |    | 4.93%   |    | 5.02%   |    |  |    |  | N/A |    |         |
| Average receive rate (3) |    | 4.83%     |    | 4.38%   |    | 4.82%   |    |  |    |  | N/A |    |         |

(1) Estimated rate, reflective of forward LIBOR plus the spread over LIBOR applicable to variable-rate borrowing.

(2) Notional amounts outstanding at each period-end.

(3) Estimated rate, reflective of forward LIBOR.

In accordance with the terms of its \$2.725 billion senior secured credit facility, we were 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 \$2.725 billion senior secured credit facility. On October 25, 2005, we 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 effective date of the four contracts was October 27, 2005, and the annual weighted-average interest rate of the four contracts is 4.71%. On April 6, 2006, we entered into three interest rate swap contracts with terms of five years and notional amounts of \$100 million each, for a total of \$300 million and fixed interest rates ranging from 5.263% to 5.266%. The effective date of the three contracts was May 8, 2006, and the annual weighted-average interest rate of the three contracts is 5.26%. On September 5, 2007, we entered into two interest rate swap contracts with terms of nine months and notional amounts of \$197 million and \$181 million, for a total of \$378 million, and fixed interest rates of 5.01%. The effective date of the \$197 million contract was September 17, 2007, and the effective date of the \$181 million contract was October 18, 2007. Under all of these contracts, we pay a fixed interest rate against a variable interest rate based on the 90-day LIBOR rate. The applicable 90-day LIBOR rate as of September 30, 2007 for the \$960 million swaps and the \$300 million swaps was 5.36%. The applicable 90-day LIBOR rate as of September 30, 2007 relating to the \$197 million swap was 5.69%. The applicable 90-day LIBOR rate as of October 18, 2007 relating to the \$181 million swap was 5.21%.

#### ITEM 4. CONTROLS AND PROCEDURES

Our management, under the supervision and with the participation of our principal executive officer and principal financial officer, have evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2007, which is the end of the period covered by this Quarterly Report on Form 10-Q. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well-designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on that evaluation, our principal executive officer and principal financial officer have concluded that these disclosure controls and procedures are sufficient to provide that (a) material information relating to us, including our consolidated subsidiaries, is made known to these officers by other employees of us and our consolidated subsidiaries, particularly material information related to the period for which this periodic report is being prepared; and (b) this information is recorded, processed, summarized, evaluated and reported, as applicable, within the time periods specified in the rules and forms of the Securities and Exchange Commission.

There were no changes that occurred during the fiscal quarter covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonable likely to materially affect, our internal controls over financial reporting.

## PART II. OTHER INFORMATION

#### ITEM 1. LEGAL PROCEEDINGS

Information in response to this Item is incorporated by reference to the information set forth in Note 10: Commitments and Contingencies in the Notes to the Consolidated Financial Statements in Part I of this Quarterly Report on Form 10-Q.

#### ITEM 6. EXHIBITS

| Exhibit | Description of Exhibit |
|---------|------------------------|
|---------|------------------------|

|       |                                                                                                    |
|-------|----------------------------------------------------------------------------------------------------|
| 31.1* | CEO Certification pursuant to rule 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934. |
|-------|----------------------------------------------------------------------------------------------------|

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- 31.2\* CFO Certification pursuant to rule 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934.
- 32.1\* CEO Certification pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of The Sarbanes-Oxley Act of 2002.
- 32.2\* CFO Certification pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of The Sarbanes-Oxley Act of 2002.

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\* Filed herewith

**SIGNATURES**



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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.

PENN NATIONAL GAMING, INC.

November 8, 2007

By:

/s/ William J. Clifford

William J. Clifford

Senior Vice President Finance and Chief Financial  
Officer (Principal Financial Officer and Principal  
Accounting Officer)

**EXHIBIT INDEX**

| <b>Exhibit</b> | <b>Description of Exhibit</b>                                                                                               |
|----------------|-----------------------------------------------------------------------------------------------------------------------------|
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