

Maryland Lottery and Gaming Control Commission
September 19, 2013

Penn Cecil Maryland, Inc. – Corporate Restructuring and Spin-Off

EXECUTIVE SUMMARY

Before the Commission is a proposed corporate restructuring and spin-off (Spin-Off) by Penn National Gaming, Inc. (Penn) of certain of its real property and other assets into Gaming and Leisure Properties, Inc. (GLPI), a newly formed real estate investment trust (REIT). Among the assets being spun off by Penn is Penn Cecil Maryland, Inc. (Licensee), the video lottery facility licensee that operates the Hollywood Casino Perryville (Hollywood Casino).

If implemented, the Spin-Off would effect a change in control of Hollywood Casino that may impact Hollywood Casino's status and operations, and, ultimately, the State's interests. Therefore, the Commission is required to review and approve the Spin-Off before it is implemented.

Staff did not evaluate, and specifically does not offer any opinion about, whether the Spin-Off would effectively meet the requirements of Ann. Code of Md., State Gov't (SG) § 9-1A-05(d), which prohibits multiple ownership of video lottery facilities in Maryland.

Rationale for the Transaction

GLPI believes that the operation of the gaming and property businesses within the current Penn structure presents significant obstacles to successfully achieving desired levels of growth. GLPI expects the Spin-Off to facilitate strategic expansion opportunities for the property business by providing GLPI with the ability to: (i) pursue transactions with other gaming operators that would not pursue similar transactions with Penn as a current competitor; (ii) raise equity to fund acquisitions on significantly more favorable terms than those that would be available to Penn; (iii) diversify into different businesses in which Penn, as a practical matter, could not diversify, such as hotels, entertainment facilities, and office space; and (iv) pursue certain transactions that Penn otherwise would be disadvantaged by or precluded from pursuing due to regulatory constraints. For example, regulatory constraints in gaming states such as Maryland restrict the number of licensed gaming facilities that an entity may own. GLPI believes that its REIT structure will allow it to pursue gaming facilities in those jurisdictions that Penn could not pursue.

According to Penn, the proposed sale-leaseback structure allows GLPI, as a REIT, to finance the purchase of the acquired real estate at favorable rates and to obtain a steady income stream pursuant to a long-term triple net lease with Penn, a financially sound tenant. The transaction also allows Penn to pay down some of its existing debt.

The Spin-Off

The Spin-Off is very complicated business reorganization. The post-Spin-Off organization chart may be instructive. The Spin-Off is fully described and analyzed in the privileged memorandum

that the Attorney General's Office provided to the Commission, but is summarized herein as broadly as possible:

- Penn proposes to spin off substantially all of the assets and liabilities associated with Penn's real property interests and real estate development business, as well as the assets and liabilities of the Licensee and another casino licensee, into a newly formed wholly owned subsidiary, GLPI. Penn will then distribute all of the shares of common stock of GLPI to holders of Penn common stock and Penn Class C preferred stock.
- No capital is being raised by GLPI as part of the Spin-Off.
- Immediately following the stock distribution, Penn shareholders will own 100% of the outstanding common stock of Penn and 100% of the outstanding common stock of GLPI. GLPI will elect to be taxed as a REIT for federal income tax purposes commencing with the tax year beginning on January 1, 2014.
- Penn has received a private letter ruling from the IRS approving the tax treatment of the Spin-Off provided it is executed in a series of transactions as described in the private letter ruling.
- GLPI will be a publicly-traded REIT primarily engaged in the property business, which will consist of owning, developing, managing, and leasing gaming and related facilities.
- Initially, GLPI's portfolio will consist of 19 gaming and related facilities that Penn currently owns. GLPI will lease back 17 of those gaming facilities to Penn, for use by Penn's subsidiaries, under a 35-year Master Lease. The Licensee will continue to operate the Hollywood Casino, which will not be among the properties subject to the Master Lease.
- GLPI will own substantially all of its assets through a subsidiary, GLP Capital, LP (GLP Capital). GLP Capital will have GLPI as its general partner and GLP Capital Partners as its limited partner.
- The Licensee will be directly owned by GLP Holdings, Inc. (GLP Holdings), a subsidiary of GLP Capital, and together with GLP Holdings, will elect to be treated as a taxable REIT subsidiary for federal income tax purposes. GLPI intends to diversify its portfolio over time, including by acquiring properties from competitors of Penn and by acquiring properties outside the gaming industry that it will lease to third parties.
- As part of the Spin-Off, the GLP entities will enter into separate agreements to address functional areas after the Spin-Off, including: unsecured senior credit facilities; separation and distribution; transition services; property leases; employee matters; and tax matters.

Staff reviewed hundreds of pages of documents and obtained information from Penn, and analyzed the Spin-Off as to whether the restructure – and the resulting transfer of Licensee would negatively affect the State or the Licensee. *See* SG § 9-1A-19.

Effect of the Spin-Off on License Hollywood Casino

The Spin-Off is a sale-leaseback of substantially all of Penn's real estate assets and is being undertaken, in part, to take advantage of the following standard financial benefits generally available in such transactions: (i) for Penn, the ability to realize the value associated with its real estate and to obtain an infusion of new capital while continuing to have the use of the property; (ii) for GLPI, as a REIT, the ability to finance the acquisition of real estate at favorable rates and

to obtain a long-term steady income stream, in the form of rent, from a financially sound tenant; and (iii) for each, certain favorable tax treatment associated with sale-leaseback transactions and REITs generally. Penn and GLPI are also undertaking the Spin-Off for other strategic and regulatory reasons, including Penn's ability to seek another Maryland license.

The Spin-Off will result in the Licensee changing owners; *i.e.*, it will change from a subsidiary in the Penn group to a taxable REIT subsidiary of the GLPI group. However, the Licensee will be one of two existing Penn subsidiaries that will remain intact when it becomes a GLPI subsidiary. The Licensee's Maryland-based management and personnel will remain unchanged, and, except for certain administrative services that will be supplied for a time by Penn and subsequently transitioned to GLPI, Penn states that the Licensee will continue to operate as a largely self-contained unit, with most of the Licensee's day-to-day operations and administrative functions managed from the Licensee's facility in Perryville. In that respect, the parties' execution of the Spin-Off would not appear to put the Licensee or the State in a less advantageous position than they currently occupy. However, aspects of the Spin-Off may present possible restrictions on the Licensee's activities:

1. Licensee as a taxable REIT subsidiary

REITs are subject to a number of qualification requirements, including limitations on the sources of their income and the types of assets that they may own. A taxable REIT subsidiary provides a REIT with the ability to carry on certain business activities that might disqualify the REIT if the REIT engaged in those activities directly. So that taxable income from the taxable REIT subsidiary's activities is not attributed to the REIT, the taxable REIT subsidiary is taxable at the corporate level as a regular C corporation. Thus, a taxable REIT subsidiary generally is subject to corporate income tax on its earnings, which may reduce the cash flow that it is able to generate. The taxable REIT subsidiary rules also limit the deductibility of interest paid or accrued by a taxable REIT subsidiary to its parent REIT to ensure that the taxable REIT subsidiary is subject to an appropriate level of corporate taxation. Further, there is a 100% excise tax on transactions between a taxable REIT subsidiary and its parent REIT or the REIT's tenants that are not conducted on an arms-length basis.

Staff is not aware of the current arrangements between the Licensee and Penn regarding the allocation of responsibility for the payment of tax on the Licensee's income, or whether tax benefits and deductions are available to the Licensee. The Licensee's election to be treated as a taxable REIT subsidiary may cause it to have an increased tax burden and to perhaps operate with a reduced cash flow. The possible imposition of a punitive excise tax on prohibited transactions may subject the Licensee to material penalties, even if conducted in good faith. Finally, as a REIT, GLPI will be significantly less flexible than Penn in terms of the transactions it may engage in and the investments that it may make and consequently, may be less able to act as a source of strength to the Licensee.

2. Covenants contained in GLP Capital's financing agreements

GLP Capital's Senior Credit Facilities will contain certain negative covenants applicable to all members of GLP Capital's consolidated Group, which includes the Licensee. These negative covenants may include prohibitions on the Licensee permitting liens on its property, and on certain transactions.

Staff is aware of only the general language in the Credit Facilities Term Sheet, so it has not determined the terms or extent of these negative covenants. However, they could have a material impact on the Licensee's operations and the manner in which it will operate after the Spin-Off. Moreover, any covenant limiting the Licensee's ability to permit a lien on its property may have implications for the State if it were to attempt to place a lien on gaming proceeds contained in a Licensee-owned bank account or otherwise.

3. Potential conflict of interest

As noted, Staff did not evaluate whether the restructure resulting from the Spin-Off will divest Penn of the Licensee. *See* SG § 9-1A-05(d)(2). However, it is of concern that, after the Spin-Off, two individuals will have overlapping management positions as to both GLPI and Penn. Penn and GLPI plan to adopt governance guidelines prior to the Spin-Off that will require the reporting of an actual or apparent conflict of interest to a designated independent director so the conflict may be evaluated and resolved. For example, at some point Penn and GLPI may wish to pursue the same corporate opportunity, such as the development of a new gaming facility or the pursuit of a gaming license. If Penn were to effectively control GLPI, a situation may arise in which management of Penn allocates loss or risk between the companies in a way that would not be in the best interests of GLPI and, directly or indirectly, the Licensee.

Conclusion and Recommendations

Staff did not evaluate, and specifically does not offer any opinion about, whether the Spin-Off would effectively meet the requirements of SG § 9-1A-05(d).

Based on the review of the documents and information provided to Staff, it is Staff's view that the Spin-Off does not put the State in a less advantageous position than it would have been if the Licensee had not proposed the Spin-Off and had continued its operations under its current corporate ownership structure. Staff recommends approval of the Spin-Off. However, given the concerns outlined above, approval should be conditioned on GLPI's demonstration, to Staff's satisfaction, of compliance with the following conditions on its approval of the Spin-Off:

1. All documents that were submitted to the Commission in draft must be executed with no material changes, and there will be no material changes in the proposed transaction as approved in the IRS private letter ruling.
2. Confirm that all required consents to the ownership change have been received and that the ownership change does not violate any material agreements to which the Licensee or its owners are a party.
3. GLPI and Penn must strengthen their conflict resolution procedures to address any conflict that arises between GLPI and Penn that may have a detrimental effect on the Licensee by, for example, requiring: (i) that the parties notify the Commission when such a conflict arises and that they submit information about the conflict and its proposed resolution for the Commission's review and approval; (ii) that the Licensee, perhaps as part of its annual report, submit information demonstrating the level of GLPI's dependence on Penn; (iii) that an individual who will be a director of both Penn and

GLPI refrain from discussing, or participating in, any Penn matters that may have an effect on the Licensee; and (iv) that the Boards of Directors of Penn and GLPI consider each establishing a conflicts committee consisting of independent directors, which would meet to consider any potential conflict involving the Licensee and would each consent before a proposed transaction involving a conflict concerning the Licensee may be consummated.

4. The Commission should be made aware of the terms of the negative covenants in the senior credit facilities at the earliest opportunity so that it may properly assess them.