MAGELLAN HEALTH SERVICES INC
Form 10-Q
July 25, 2013

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended June 30, 2013

Or

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

For the transition period from to
Commission File No. 1-6639

MAGELLAN HEALTH SERVICES, INC.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**58-1076937** (IRS Employer Identification No.)
55 Nod Road, Avon, Connecticut (Address of principal executive offices)	**06001** (Zip code)

(860) 507-1900
(Registrant's telephone number, including area code)

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 twelve 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 ý No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No o

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

Large accelerated filer ý	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

The number of shares of the registrant's Ordinary Common Stock outstanding as of June 30, 2013 was 26,846,274.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands, except per share amounts)

	December 31, 2012	June 30, 2013 (unaudited)
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 189,464	$ 179,219
Restricted cash	226,554	189,468
Accounts receivable, less allowance for doubtful accounts of $4,612 and $4,513 at December 31, 2012 and June 30, 2013, respectively	138,253	165,378
Short-term investments (restricted investments of $88,332 and $125,922 at December 31, 2012 and June 30, 2013, respectively)	201,127	228,634
Deferred income taxes	31,698	31,567
Pharmaceutical inventory	45,727	49,877
Other current assets (restricted deposits of $20,846 and $24,927 at December 31, 2012 and June 30, 2013, respectively)	38,595	46,869
Total Current Assets	871,418	891,012
Property and equipment, net	136,548	163,931
Restricted long-term investments	32,563	26,230
Other long-term assets	9,730	15,427
Goodwill	426,939	426,939
Other intangible assets, net	34,935	30,347
Total Assets	$ 1,512,133	$ 1,553,886
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 17,081	$ 12,146
Accrued liabilities	100,778	74,646
Medical claims payable	198,429	205,152
Other medical liabilities	76,914	76,575
Current maturities of long-term capital lease obligations		2,834
Total Current Liabilities	393,202	371,353
Long-term capital lease obligations		24,673
Deferred income taxes	34,086	34,384
Tax contingencies	60,697	62,858
Deferred credits and other long-term liabilities	6,815	7,188
Total Liabilities	494,800	500,456
Preferred stock, par value $.01 per share		
Authorized 10,000 shares at December 31, 2012 and June 30, 2013 Issued and outstanding none		
Ordinary common stock, par value $.01 per share		
Authorized 100,000 shares at December 31, 2012 and June 30, 2013 Issued and outstanding 45,928 and 27,353 shares at December 31, 2012, respectively, and 46,377 and 26,846 shares at June 30, 2013, respectively	459	464
Multi-Vote common stock, par value $.01 per share		
Authorized 40,000 shares Issued and outstanding none		

Other Stockholders' Equity:				
Additional paid-in capital		848,238		872,977
Retained earnings		975,232		1,034,770
Accumulated other comprehensive loss		(35)		(182)
Ordinary common stock in treasury, at cost, 18,575 and 19,531 shares at December 31, 2012 and June 30, 2013, respectively		(806,561)		(854,599)
Total Stockholders' Equity		1,017,333		1,053,430
Total Liabilities and Stockholders' Equity	$	1,512,133	$	1,553,886

See accompanying notes to consolidated financial statements.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(In thousands, except per share amounts)

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2013	Six Months Ended June 30, 2012	Six Months Ended June 30, 2013
Net revenue:				
Managed care and other	$ 716,998	$ 752,151	$ 1,403,057	$ 1,479,791
Dispensing	88,475	90,597	175,629	184,718
Total net revenue	805,473	842,748	1,578,686	1,664,509
Cost and expenses:				
Cost of care	521,830	542,826	1,027,123	1,072,757
Cost of goods sold	82,855	84,979	163,893	173,587
Direct service costs and other operating expenses(1)	140,333	144,497	276,922	284,124
Depreciation and amortization	15,152	16,946	29,933	33,116
Interest expense	576	792	1,176	1,402
Interest income	(857)	(358)	(1,269)	(711)
	759,889	789,682	1,497,778	1,564,275
Income before income taxes	45,584	53,066	80,908	100,234
Provision for income taxes	18,611	21,586	33,145	40,696
Net income	26,973	31,480	47,763	59,538
Net income per common share basic (See Note B)	$ 0.99	$ 1.17	$ 1.75	$ 2.21
Net income per common share diluted (See Note B)	$ 0.97	$ 1.15	$ 1.72	$ 2.17
Other comprehensive (loss) income:				
Unrealized (losses) gains on available-for-sale securities(2)	(85)	(70)	88	(147)
Comprehensive income	$ 26,888	$ 31,410	$ 47,851	$ 59,391

(1) Includes stock compensation expense of $4,365 and $4,602 for the three months ended June 30, 2012 and 2013, respectively, and $9,467 and $10,240 for the six months ended June 30, 2012 and 2013, respectively.

(2) Net of income tax provision (benefit) of $(55) and $(47) for the three months ended June 30, 2012 and 2013, respectively, and $56 and $(99) for the six months ended June 30, 2012 and 2013, respectively.

See accompanying notes to consolidated financial statements.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE SIX MONTHS ENDED JUNE 30,

(Unaudited)

(In thousands)

	2012	2013
Cash flows from operating activities:		
Net income	$ 47,763	$ 59,538
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	29,933	33,116
Non-cash interest expense	360	368
Non-cash stock compensation expense	9,467	10,240
Non-cash income tax expense	6,906	1,335
Non-cash amortization on investments	3,720	4,884
Cash flows from changes in assets and liabilities, net of effects from acquisitions of businesses:		
Restricted cash	(22,845)	37,086
Accounts receivable, net	1,428	(27,361)
Pharmaceutical inventory	1,213	(4,150)
Other assets	(4,307)	(8,281)
Accounts payable and accrued liabilities	(20,022)	(29,643)
Medical claims payable and other medical liabilities	20,208	6,384
Tax contingencies	1,478	1,349
Other	(270)	2,044
Net cash provided by operating activities	75,032	86,909
Cash flows from investing activities:		
Capital expenditures	(36,877)	(27,035)
Purchase of investments	(143,155)	(165,372)
Maturity of investments	150,890	139,068
Other		(7,900)
Net cash used in investing activities	(29,142)	(61,239)
Cash flows from financing activities:		
Payments to acquire treasury stock		(49,462)
Proceeds from exercise of stock options and warrants	3,003	16,110
Payments on capital lease obligations		(1,816)
Other	(735)	(747)
Net cash provided by (used in) financing activities	2,268	(35,915)
Net increase (decrease) in cash and cash equivalents	48,158	(10,245)
Cash and cash equivalents at beginning of period	119,862	189,464
Cash and cash equivalents at end of period	$ 168,020	$ 179,219
Supplemental cash flow data:		
Non-cash investing activites:		
Property and equipment acquired under capital leases	$	$ 29,323

See accompanying notes to consolidated financial statements.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2013

(Unaudited)

NOTE A General

Basis of Presentation

The accompanying unaudited consolidated financial statements of Magellan Health Services, Inc., a Delaware corporation ("Magellan"), include the accounts of Magellan, its majority owned subsidiaries, and all variable interest entities ("VIEs") for which Magellan is the primary beneficiary (together with Magellan, the "Company"). The financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the Securities and Exchange Commission's (the "SEC") instructions to Form 10-Q. Accordingly, the financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring adjustments considered necessary for a fair presentation, have been included. The results of operations for the three and six months ended June 30, 2013 are not necessarily indicative of the results to be expected for the full year. All significant intercompany accounts and transactions have been eliminated in consolidation.

The Company has evaluated subsequent events for recognition or disclosure in the consolidated financial statements filed on this Form 10-Q and no events have occurred that require disclosure.

These unaudited consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements for the year ended December 31, 2012 and the notes thereto, which are included in the Company's Annual Report on Form 10-K filed with the SEC on February 28, 2013.

Business Overview

The Company is engaged in the specialty managed healthcare business. Through 2005, the Company predominantly operated in the managed behavioral healthcare business. As a result of certain acquisitions, the Company expanded into radiology benefits management and specialty pharmaceutical management during 2006, and into Medicaid administration during 2009. The Company provides services to health plans, insurance companies, employers, labor unions and various governmental agencies. The Company's business is divided into the following five segments, based on the services it provides and/or the customers that it serves, as described below.

Managed Behavioral Healthcare

Two of the Company's segments are in the managed behavioral healthcare business. This line of business generally reflects the Company's coordination and management of the delivery of behavioral healthcare treatment services that are provided through its contracted network of third-party treatment providers, which includes psychiatrists, psychologists, other behavioral health professionals, psychiatric hospitals, general medical facilities with psychiatric beds, residential treatment centers and other treatment facilities. The treatment services provided through the Company's provider network include outpatient programs (such as counseling or therapy), intermediate care programs (such as intensive outpatient programs and partial hospitalization services), inpatient treatment and crisis intervention services. The Company generally does not directly provide or own any provider of treatment services,

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

NOTE A General (Continued)

although it does employ licensed behavioral health counselors to deliver non-medical counseling under certain government contracts.

The Company provides its management services primarily through: (i) risk-based products, where the Company assumes all or a substantial portion of the responsibility for the cost of providing treatment services in exchange for a fixed per member per month fee, (ii) administrative services only ("ASO") products, where the Company provides services such as utilization review, claims administration and/or provider network management, but does not assume responsibility for the cost of the treatment services, and (iii) employee assistance programs ("EAPs") where the Company provides short-term outpatient behavioral counseling services.

The managed behavioral healthcare business is managed based on the services provided and/or the customers served, through the following two segments:

Commercial. The Managed Behavioral Healthcare Commercial segment ("Commercial") generally reflects managed behavioral healthcare services and EAP services provided under contracts with health plans and insurance companies for some or all of their commercial, Medicaid and Medicare members, as well as with employers, including corporations, governmental agencies, and labor unions. Commercial's contracts encompass risk-based, ASO and EAP arrangements.

Public Sector. The Managed Behavioral Healthcare Public Sector segment ("Public Sector") generally reflects the management of behavioral health services provided to recipients under Medicaid and other state sponsored programs under contracts with state and local governmental agencies. Public Sector contracts also include management services for the integrated physical, behavioral and pharmaceutical care for special populations covered under Medicaid and other government sponsored programs. Public Sector contracts encompass either risk-based or ASO arrangements.

Radiology Benefits Management

The Radiology Benefits Management segment ("Radiology Benefits Management") generally reflects the management of the delivery of diagnostic imaging and other therapeutic services to ensure that such services are clinically appropriate and cost effective. The Company's radiology benefits management services currently are provided under contracts with health plans and insurance companies for some or all of their commercial, Medicaid and Medicare members. The Company also contracts with state and local governmental agencies for the provision of such services to Medicaid recipients. The Company offers its radiology benefits management services through risk-based contracts, where the Company assumes all or a substantial portion of the responsibility for the cost of providing diagnostic imaging services, and through ASO contracts, where the Company provides services such as utilization review and claims administration, but does not assume responsibility for the cost of the imaging services.

Pharmacy Solutions

The Pharmacy Solutions segment ("Pharmacy Solutions") comprises products and solutions that provide clinical and financial management of drugs paid under medical and pharmacy benefit programs.

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

NOTE A General (Continued)

The Company's Pharmacy Solutions services include (i) pharmacy benefit management ("PBM") programs; (ii) specialty contracting and formulary optimization programs; (iii) specialty pharmaceutical dispensing operations; (iv) medical pharmacy management programs; and (v) programs for the integrated management of drugs that treat complex conditions, regardless of site of service or benefit reimbursement. The Company's pharmacy solutions are provided under contracts with health plans, employers, Medicaid MCOs, state Medicaid programs, and other government agencies, and encompass risk-based and fee-for-service ("FFS") arrangements.

Beginning in the first quarter of 2013, the Company underwent organizational changes. As a result of these changes, the Company concluded that changes to its reportable segments were warranted. This segment contains the operating segments previously defined as the Specialty Pharmaceutical Management segment and the Medicaid Administration segment. Prior period balances have been reclassified to reflect this change.

Corporate

This segment of the Company is comprised primarily of operational support functions such as sales and marketing and information technology, as well as corporate support functions such as executive, finance, human resources and legal.

Summary of Significant Accounting Policies

Recent Accounting Pronouncements

In October 2012, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2012-04, "Technical Corrections and Improvements" ("ASC 2012-04"). The amendments in this update cover a wide range of Topics in the Accounting Standards Codification. These amendments include technical corrections and improvements to the Accounting Standards Codification and conforming amendments related to fair value measurements. The amendments in this guidance that will not have transition guidance are effective upon issuance. The amendments that are subject to transition guidance are effective for fiscal periods beginning after December 15, 2012 and were adopted by the Company during the quarter ended March 31, 2013. The guidance did not impact the Company's consolidated results of operations, financial position, or cash flows.

In February 2013, the FASB issued ASU No. 2013-02, "Comprehensive Income (Topic 220): Reporting of Amounts Reclassified out of Accumulated Comprehensive Income" ("ASU 2013-02"). ASU 2013-02 requires companies to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under generally accepted accounting principles ("GAAP") to be reclassified in its entirety to net income. Entities are required to provide information about significant reclassifications by component, and to present those reclassifications either on the face of the statement where net income is presented or in the notes. For other amounts that are not required to be reclassified in their entirety to net income, entities are required to cross-reference other disclosures that provide additional details about those amounts. The amendments in this ASU do not change the current requirements for reporting net income or other comprehensive income in financial statements. The amendments in this

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

NOTE A General (Continued)

ASU are effective prospectively for reporting periods beginning after December 15, 2012 and were adopted by the Company during the quarter ended March 31, 2013. The guidance did not impact the Company's consolidated results of operations, financial position, or cash flows.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Significant estimates of the Company include, among other things, accounts receivable realization, valuation allowances for deferred tax assets, valuation of goodwill and intangible assets, medical claims payable, other medical liabilities, stock compensation assumptions, tax contingencies and legal liabilities. Actual results could differ from those estimates.

Managed Care and Other Revenue

Managed Care Revenue. Managed care revenue, inclusive of revenue from the Company's risk, EAP and ASO contracts, is recognized over the applicable coverage period on a per member basis for covered members. The Company is paid a per member fee for all enrolled members, and this fee is recorded as revenue in the month in which members are entitled to service. The Company adjusts its revenue for retroactive membership terminations, additions and other changes, when such adjustments are identified, with the exception of retroactivity that can be reasonably estimated. The impact of retroactive rate amendments is generally recorded in the accounting period that terms to the amendment are finalized, and that the amendment is executed. Any fees paid prior to the month of service are recorded as deferred revenue. Managed care revenues approximated $638.0 million and $1,239.8 million for the three and six months ended June 30, 2012, respectively, and $654.6 million and $1,284.3 million for the three and six months ended June 30, 2013, respectively.

Fee-For-Service and Cost-Plus Contracts. The Company has certain fee-for-service contracts, including cost-plus contracts, with customers under which the Company recognizes revenue as services are performed and as costs are incurred. Revenues from these contracts approximated $35.1 million and $71.0 million for the three and six months ended June 30, 2012, respectively, and $51.0 million and $100.3 million for the three and six months ended June 30, 2013, respectively.

Block Grant Revenues. Public Sector has a contract that is partially funded by federal, state and county block grant money, which represents annual appropriations. The Company recognizes revenue from block grant activity ratably over the period to which the block grant funding applies. Block grant revenues were approximately $29.0 million and $57.9 million for the three and six months ended June 30, 2012, respectively, and $31.4 million and $64.6 million for the three and six months ended June 30, 2013, respectively.

Performance-Based Revenue. The Company has the ability to earn performance-based revenue under certain risk and non-risk contracts. Performance-based revenue generally is based on either the

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

NOTE A General (Continued)

ability of the Company to manage care for its clients below specified targets, or on other operating metrics. For each such contract, the Company estimates and records performance-based revenue after considering the relevant contractual terms and the data available for the performance-based revenue calculation. Pro-rata performance-based revenue may be recognized on an interim basis pursuant to the rights and obligations of each party upon termination of the contracts. Performance-based revenues were $3.9 million and $11.9 million for the three and six months ended June 30, 2012, respectively, and $1.5 million and $3.4 million for the three and six months ended June 30, 2013, respectively.

Rebate Revenue. The Company administers a rebate program for certain clients through which the Company coordinates the achievement, calculation and collection of rebates and administrative fees from pharmaceutical manufacturers on behalf of clients. Each period, the Company estimates the total rebates earned based on actual volumes of pharmaceutical purchases by the Company's clients, as well as historical and/or anticipated sharing percentages. The Company earns fees based upon the volume of rebates generated for its clients. The Company does not record as rebate revenue any rebates that are passed through to its clients. Total rebate revenues were $9.3 million and $19.0 million for the three and six months ended June 30, 2012, respectively, and $8.1 million and $16.8 million for the three and six months ended June 30, 2013, respectively.

Dispensing Revenue

The Company recognizes dispensing revenue, which includes the co-payments received from members of the health plans the Company serves, when the specialty pharmaceutical drugs are shipped. At the time of shipment, the earnings process is complete; the obligation of the Company's customer to pay for the specialty pharmaceutical drugs is fixed, and, due to the nature of the product, the member may neither return the specialty pharmaceutical drugs nor receive a refund. Revenues from the dispensing of specialty pharmaceutical drugs on behalf of health plans were $88.5 million and $175.6 million for the three and six months ended June 30, 2012, respectively, and $90.6 million and $184.7 million for the three and six months ended June 30, 2013, respectively.

Significant Customers

Consolidated Company

The Company provides behavioral healthcare management and other related services to approximately 685,000 members in Maricopa County, Arizona, (the "Maricopa Contract").

Under the Maricopa Contract, the Company is responsible for providing covered behavioral health services to persons eligible under Title XIX (Medicaid) and Title XXI (State Children's Health Insurance Program) of the Social Security Act, non-Title XIX and non-Title XXI eligible children and adults with a serious mental illness ("SMI"), and to certain non-Title XIX and non-Title XXI adults with behavioral health or substance abuse disorders. The Maricopa Contract began on September 1, 2007 and extends through September 30, 2013 unless sooner terminated by the parties. The State of Arizona has the right to terminate the Maricopa Contract for cause, as defined, upon ten days' notice with an opportunity to cure, and without cause immediately upon notice from the State. The Maricopa

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

NOTE A General (Continued)

Contract generated net revenues of $383.2 million and $367.2 million for the six months ended June 30, 2012 and 2013, respectively.

The contract is for the management of the publicly funded behavioral health system that delivers mental health, substance abuse and crisis services for adults, youth, and children, and includes an integrated behavioral and physical health care system for individuals with a SMI. On March 25, 2013, the Company was notified that Magellan Complete Care of Arizona, a joint venture owned 80% by the Company and 20% by Vanguard/Phoenix Health Plan, was not selected as the Regional Behavioral Health Authority ("RBHA") in GSA6 ("Maricopa County"). On April 3, 2013, the Company announced that it filed a formal protest regarding the State's decision to award the RBHA in Maricopa County to another vendor. On April 17, 2013, the Arizona Department of Health Services denied the Company's protest. On May 9, 2013, the Company filed an appeal of the denial of its protest (the "Appeal") with the Arizona Department of Administration (the "DOA"), the agency responsible for considering appeals of procurement protest denials. The Company also filed with the DOA a motion to stay the award and implementation of the contract pending a decision on the Appeal. On May 21, 2013, the DOA granted the Company's motion and issued a stay of the award and implementation of the contract pending resolution of the Appeal by the DOA (the "Stay"). On May 21, 2013, the winning bidder for the contract filed a motion to vacate the Stay, asking the DOA to eliminate the Stay. The Arizona Health Care Cost Containment System (the Arizona Medicaid Agency) and the Arizona Department of Health Services (the agency that administered the award of the contract) also subsequently filed requests with the DOA to reconsider and vacate the Stay. On June 13, 2013 the DOA ruled that the Stay will remain in effect and referred the Appeal for a hearing before an independent administrative law judge in the Arizona Office of Administrative Hearings (the "OAH"). The OAH has scheduled a hearing on the Appeal for August 12-14, 2013. There is no assurance that the Company will prevail on the Appeal or that the Stay will remain in effect.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

NOTE A General (Continued)

By Segment

In addition to the Maricopa Contract previously discussed, the following customers generated in excess of ten percent of net revenues for the respective segment for the six months ended June 30, 2012 and 2013 (in thousands):

Segment	Term Date	2012	2013
Commercial			
Customer A	December 31, 2013(1)	$ 96,106	$ 103,460
Customer B	December 31, 2019	67,381	70,919
Customer C	December 31, 2012 to December 14, 2013(2)(3)	60,923	38,776
Public Sector			
Customer D	June 30, 2014(4)	111,259	129,471
Radiology Benefits Management			
Customer E	December 31, 2015	53,405	60,602
Customer F	June 30, 2014	29,049	30,580
Customer G	July 31, 2015	28,092	32,708
Customer H	January 31, 2014	18,333	22,230
Pharmacy Solutions			
Customer I	November 30, 2013 to December 31, 2013(2)	64,651	65,335
Customer J	September 1, 2013 to April 29, 2014(2)	30,643	28,478*
Customer K	September 27, 2013 to December 31, 2013(2)	33,746	43,274
Customer L	September 30, 2013(5)	37,826	31,466

* Revenue amount did not exceed ten percent of net revenues for the respective segment for the period presented. Amount is shown for comparative purposes only.

(1) The customer has informed the Company that, after a competitive evaluation process, it has decided not to renew its contract after the contract expires on December 31, 2013.

(2) The customer has more than one contract. The individual contracts are scheduled to terminate at various points during the time period indicated above.

(3) Revenues for the six months ended June 30, 2012 of $25.9 million relate to a contract that terminated as of December 31, 2012. The customer has informed the Company that is has decided not to renew the remaining contract after the contract expires on December 14, 2013.

(4) Contract has options for the customer to extend the term for two additional one-year periods.

(5) This customer represents a subcontract with a Public Sector customer and is eliminated in consolidation.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

NOTE A General (Continued)

Concentration of Business

The Company also has a significant concentration of business with various counties in the State of Pennsylvania (the "Pennsylvania Counties") which are part of the Pennsylvania Medicaid program, and with various areas in the State of Florida (the "Florida Areas") which are part of the Florida Medicaid program. Net revenues from the Pennsylvania Counties in the aggregate totaled $182.4 million and $178.0 million for the six months ended June 30, 2012 and 2013, respectively. Net revenues from the Florida Areas in the aggregate totaled $67.7 million and $66.3 million for the six months ended June 30, 2012 and 2013, respectively.

The Company's contracts with customers typically have terms of one to three years, and in certain cases contain renewal provisions (at the customer's option) for successive terms of between one and two years (unless terminated earlier). Substantially all of these contracts may be immediately terminated with cause and many of the Company's contracts are terminable without cause by the customer or the Company either upon the giving of requisite notice and the passage of a specified period of time (typically between 60 and 180 days) or upon the occurrence of other specified events. In addition, the Company's contracts with federal, state and local governmental agencies generally are conditioned on legislative appropriations. These contracts generally can be terminated or modified by the customer if such appropriations are not made.

Fair Value Measurements

The Company currently does not have non-financial assets and non-financial liabilities that are required to be measured at fair value on a recurring basis. Financial assets and liabilities are to be measured using inputs from the three levels of the fair value hierarchy, which are as follows:

Level 1 Inputs are unadjusted quoted prices in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date.

Level 2 Inputs include quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (i.e., interest rates, yield curves, etc.), and inputs that are derived principally from or corroborated by observable market data by correlation or other means (market corroborated inputs).

Level 3 Unobservable inputs that reflect the Company's assumptions about the assumptions that market participants would use in pricing the asset or liability. The Company develops these inputs based on the best information available, including the Company's data.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

NOTE A General (Continued)

In accordance with the fair value hierarchy described above, the following table shows the fair value of the Company's financial assets and liabilities that are required to be measured at fair value as of December 31, 2012 and June 30, 2013 (in thousands):

	December 31, 2012			
	Level 1	Level 2	Level 3	Total
Cash and cash equivalents(1)	$	$ 102,137	$	$ 102,137
Restricted cash(2)		82,839		82,839
Investments:				
U.S. government and agency securities	1,065			1,065
Obligations of government-sponsored enterprises(3)		6,128		6,128
Corporate debt securities		214,547		214,547
Taxable municipal bonds		11,800		11,800
Certificates of deposit		150		150
December 31, 2012	$ 1,065	$ 417,601	$	$ 418,666

	June 30, 2013			
	Level 1	Level 2	Level 3	Total
Cash and cash equivalents(4)	$	$ 74,033	$	$ 74,033
Restricted cash(5)		146,608		146,608
Investments:				
U.S. government and agency securities	1,068			1,068
Obligations of government-sponsored enterprises(3)		8,410		8,410
Corporate debt securities		244,635		244,635
Taxable municipal bonds		601		601
Certificates of deposit		150		150
June 30, 2013	$ 1,068	$ 474,437	$	$ 475,505

(1) Excludes $87.3 million of cash held in bank accounts by the Company.

(2) Excludes $143.7 million of restricted cash held in bank accounts by the Company.

(3) Includes investments in notes issued by the Federal Home Loan Bank.

(4) Excludes $105.2 million of cash held in bank accounts by the Company.

(5) Excludes $42.9 million of restricted cash held in bank accounts by the Company.

For the six months ended June 30, 2013, the Company has not transferred any assets between fair value measurement levels.

All of the Company's investments are classified as "available-for-sale" and are carried at fair value.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

NOTE A General (Continued)

If a debt security is in an unrealized loss position and the Company has the intent to sell the debt security, or it is more likely than not that the Company will have to sell the debt security before recovery of its amortized cost basis, the decline in value is deemed to be other-than-temporary and is recorded to other-than-temporary impairment losses recognized in income in the consolidated statements of comprehensive income. For impaired debt securities that the Company does not intend to sell or it is more likely than not that the Company will not have to sell such securities, but the Company expects that it will not fully recover the amortized cost basis, the credit component of the other-than-temporary impairment is recognized in other-than-temporary impairment losses recognized in income in the consolidated statements of comprehensive income and the non-credit component of the other-than-temporary impairment is recognized in other comprehensive income.

As of December 31, 2012 and June 30, 2013, there were no unrealized losses that the Company believed to be other-than-temporary. No realized gains or losses were recorded for the six months ended June 30, 2012 or 2013. The following is a summary of short-term and long-term investments at December 31, 2012 and June 30, 2013 (in thousands):

	December 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. government and agency securities	$ 1,065	$	$	$ 1,065
Obligations of government-sponsored enterprises(1)	6,126	4	(2)	6,128
Corporate debt securities	214,603	66	(122)	214,547
Taxable municipal bonds	11,805		(5)	11,800
Certificates of deposit	150			150
Total investments at December 31, 2012	$ 233,749	$ 70	$ (129)	$ 233,690

	June 30, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. government and agency securities	$ 1,068	$	$	$ 1,068
Obligations of government-sponsored enterprises(1)	8,430	1	(21)	8,410
Corporate debt securities	244,919	23	(307)	244,635
Taxable municipal bonds	602		(1)	601
Certificates of deposit	150			150
Total investments at June 30, 2013	$ 255,169	$ 24	$ (329)	$ 254,864

(1) Includes investments in notes issued by the Federal Home Loan Bank.

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

NOTE A General (Continued)

The maturity dates of the Company's investments as of June 30, 2013 are summarized below (in thousands):

	Amortized Cost	Estimated Fair Value
2013	$ 172,414	$ 172,287
2014	77,366	77,207
2015	5,389	5,370
Total investments at June 30, 2013	$ 255,169	$ 254,864

Note Receivable and Preferred Stock

During the current quarter, the Company executed a note receivable in the amount of $5.9 million and purchased preferred stock of $2.0 million from a third party. These transactions were made to support the growth initiatives involving Medicaid and other special populations.

Income Taxes

The Company's effective income tax rates were 41.0 percent and 40.6 percent for the six months ended June 30, 2012 and 2013, respectively. These rates differ from the federal statutory income tax rate primarily due to state income taxes, permanent differences between book and tax income, and changes to recorded tax contingencies. The Company also accrues interest and penalties related to unrecognized tax benefits in its provision for income taxes. The effective income tax rate for the six months ended June 30, 2013 is lower than the effective rate for the six months ended June 30, 2012 mainly due to differences in the Company's effective state tax rate.

The Company files a consolidated federal income tax return for the Company and its eighty percent or more owned subsidiaries, and the Company and its subsidiaries file income tax returns in various states and local jurisdictions. With few exceptions, the Company is no longer subject to state or local income tax assessments by tax authorities for years ended prior to 2009.

Stock Compensation

At December 31, 2012 and June 30, 2013, the Company had equity-based employee incentive plans, which are described more fully in Note 6 in the Company's Annual Report on Form 10-K for the year ended December 31, 2012. The Company recorded stock compensation expense of $4.4 million and $9.5 million for the three and six months ended June 30, 2012, respectively, and $4.6 million and $10.2 million for the three and six months ended June 30, 2013, respectively. Stock compensation expense recognized in the consolidated statements of comprehensive income for the three and six months ended June 30, 2012 and 2013 has been reduced for estimated forfeitures, estimated at four percent for both periods.

The weighted average grant date fair value of all stock options granted during the six months ended June 30, 2013 was $12.06 as estimated using the Black-Scholes-Merton option pricing model,

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

NOTE A General (Continued)

which also assumed an expected volatility of 27.86 percent based on the historical volatility of the Company's stock price.

The benefits of tax deductions in excess of recognized stock compensation expense are reported as a financing cash flow, rather than as an operating cash flow. In the six months ended June 30, 2012 and 2013, $0.4 million and $0.5 million, respectively, of benefits of such tax deductions related to stock compensation expense were realized and as such were reported as financing cash flows. For the six months ended June 30, 2012 the net change to additional paid in capital related to tax benefits (deficiencies) was $0.2 million which includes the $0.4 million of excess tax benefits offset by $(0.2) million of tax deficiencies. For the six months ended June 30, 2013, the net change to additional paid in capital related to tax benefits (deficiencies) was $(0.1) million which includes $(0.6) million of excess tax deficiencies offset by the $0.5 million of excess tax benefits.

Summarized information related to the Company's stock options for the six months ended June 30, 2013 is as follows:

	Options	Weighted Average Exercise Price
Outstanding, beginning of period	4,268,240	$ 44.35
Granted	954,133	52.54
Forfeited	(32,619)	47.70
Exercised	(359,498)	44.15
Outstanding, end of period	4,830,256	$ 45.96
Vested and expected to vest at end of period	4,772,148	$ 45.90
Exercisable, end of period	2,682,679	$ 42.70

With the exception of options granted to the Company's CEO, generally all of the Company's options granted during the six months ended June 30, 2013 vest ratably on each anniversary date over the three years subsequent to grant. During the six months ended June 30, 2013, the Company granted options to the Company's CEO which vest over four year annual installments, with 16.7 percent, 33.3 percent, 33.3 percent, and 16.7 percent vesting in 2014, 2015, 2016, and 2017, respectively. All options granted during the six months ended June 30, 2013 have a ten year life.

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

NOTE A General (Continued)

Summarized information related to the Company's nonvested restricted stock awards for the six months ended June 30, 2013 is as follows:

	Shares	Weighted Average Grant Date Fair Value
Outstanding, beginning of period	23,672	$ 42.25
Awarded	16,569	52.82
Vested	(23,672)	42.25
Forfeited		
Outstanding, ending of period	16,569	$ 52.82

Summarized information related to the Company's nonvested restricted stock units for the six months ended June 30, 2013 is as follows:

	Shares	Weighted Average Grant Date Fair Value
Outstanding, beginning of period	202,690	$ 47.38
Awarded	98,580	52.62
Vested	(93,804)	46.70
Forfeited	(2,506)	48.80
Outstanding, ending of period	204,960	$ 50.19

Grants of restricted stock awards vest on the anniversary of the grant. With the exception of restricted stock units awarded to the Company's CEO during the six months ended June 30, 2013, generally all of the Company's restricted stock units vest ratably on each anniversary over the three years subsequent to grant, assuming that the associated performance hurdle(s) for that vesting year are met. During the six months ended June 30, 2013, the Company granted restricted stock units to the Company's CEO which vest over four year annual installments, with 16.7 percent, 33.3 percent, 33.3 percent, and 16.7 percent vesting in 2014, 2015, 2016, and 2017, respectively, assuming the associated performance hurdle(s) for that vesting year are met.

Long Term Debt and Capital Lease Obligations

On December 9, 2011, the Company entered into a Senior Secured Revolving Credit Facility Credit Agreement with Citibank, N.A., Wells Fargo Bank, N.A., Bank of America, N.A., and U.S. Bank, N.A. that provides for up to $230.0 million of revolving loans with a sublimit of up to $70.0 million for the issuance of letters of credit for the account of the Company (the "2011 Credit Facility"). Citibank, N.A., has assigned a portion of its interest in the 2011 Credit Facility to Bank of Tokyo. The 2011 Credit Facility is guaranteed by substantially all of the subsidiaries of the Company and is secured by substantially all of the assets of the Company and the subsidiary guarantors. The 2011 Credit Facility will mature on December 9, 2014.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

NOTE A General (Continued)

Under the 2011 Credit Facility, the annual interest rate on Revolving Loan borrowings is equal to (i) in the case of U.S. dollar denominated loans, the sum of a borrowing margin of 0.75 percent plus the higher of the prime rate, one-half of one percent in excess of the overnight "federal funds" rate, or the Eurodollar rate for one month plus 1.00 percent, or (ii) in the case of Eurodollar denominated loans, the sum of a borrowing margin of 1.75 percent plus the Eurodollar rate for the selected interest period. The Company has the option to borrow in U.S. dollar denominated loans or Eurodollar denominated loans at its discretion. Letters of Credit issued under the Revolving Loan Commitment bear interest at the rate of 1.875 percent. The commitment commission on the 2011 Credit Facility is 0.375 percent of the unused Revolving Loan Commitment.

There were no capital lease obligations at December 31, 2012 and $27.5 million of capital lease obligations at June 30, 2013. The Company had $32.0 million and $32.4 million of letters of credit outstanding at December 31, 2012 and June 30, 2013, respectively, and no Revolving Loan borrowings at December 31, 2012 or June 30, 2013.

Reclassifications

Certain prior year amounts have been reclassified to conform with the current year presentation.

NOTE B Net Income per Common Share

The following tables reconcile income (numerator) and shares (denominator) used in the computations of net income per common share (in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	**2013**	**2012**	**2013**
Numerator:				
Net income	$ 26,973	$ 31,480	$ 47,763	$ 59,538
Denominator:				
Weighted average number of common shares outstanding basic	27,317	26,829	27,258	26,968
Common stock equivalents stock options	328	497	380	482
Common stock equivalents restricted stock	10	10	12	14
Common stock equivalents restricted stock units	61		81	26
Common stock equivalents employee stock purchase plan	1	2	1	2
Weighted average number of common shares outstanding diluted	27,717	27,338	27,732	27,492
Net income per common share basic	$ 0.99	$ 1.17	$ 1.75	$ 2.21
Net income per common share diluted	$ 0.97	$ 1.15	$ 1.72	$ 2.17

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

NOTE B Net Income per Common Share (Continued)

The weighted average number of common shares outstanding for the three and six months ended June 30, 2012 and 2013 were calculated using outstanding shares of the Company's common stock. Common stock equivalents included in the calculation of diluted weighted average common shares outstanding for the three and six months ended June 30, 2012 and 2013 represent stock options to purchase shares of the Company's common stock, restricted stock awards and restricted stock units, and stock purchased under the Employee Stock Purchase Plan.

The Company had additional potential dilutive securities outstanding representing 2.7 million and 2.1 million options for the three and six months ended June 30, 2012, respectively, and 1.2 million and 1.9 million for the three and six months ended June 30, 2013, respectively, that were not included in the computation of dilutive securities because they were anti-dilutive for the period. Had these shares not been anti-dilutive, all of these shares would not have been included in the net income per common share calculation as the Company uses the treasury stock method of calculating diluted shares.

NOTE C Business Segment Information

The accounting policies of the Company's segments are the same as those described in Note A "General." The Company evaluates performance of its segments based on income before income taxes, before stock compensation expense, depreciation and amortization, interest expense, interest income, gain on sale of assets, and special charges or benefits ("Segment Profit"). Management uses Segment Profit information for internal reporting and control purposes and considers it important in making decisions regarding the allocation of capital and other resources, risk assessment and employee compensation, among other matters. Effective September 1, 2010, Public Sector has subcontracted with Pharmacy Solutions to provide pharmacy benefits management services on a risk basis for one of Public Sector's customers. As such, revenue and cost of care related to this intersegment arrangement are eliminated. The Company's segments are defined above. The Pharmacy Solutions segment contains the operating segments previously defined as the Specialty Pharmaceutical Management segment and the Medicaid Administration segment. Prior period balances have been reclassified to reflect this change.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

NOTE C Business Segment Information (Continued)

The following tables summarize, for the periods indicated, operating results by business segment (in thousands):

	Commercial	Public Sector	Radiology Benefits Management	Pharmacy Solutions	Corporate and Elimination	Consolidated
Three Months Ended June 30, 2012						
Managed care and other revenue	$ 178,227	$ 410,136	$ 88,826	$ 56,527	$ (16,718)	$ 716,998
Dispensing revenue				88,475		88,475
Cost of care	(110,847)	(355,113)	(57,874)	(14,714)	16,718	(521,830)
Cost of goods sold				(82,855)		(82,855)
Direct service costs and other	(42,456)	(23,304)	(13,582)	(26,948)	(34,043)	(140,333)
Stock compensation expense(1)	270	269	360	236	3,230	4,365
Segment profit (loss)	$ 25,194	$ 31,988	$ 17,730	$ 20,721	$ (30,813)	$ 64,820

	Commercial	Public Sector	Radiology Benefits Management	Pharmacy Solutions	Corporate and Elimination	Consolidated
Three Months Ended June 30, 2013						
Managed care and other revenue	$ 199,538	$ 414,859	$ 92,715	$ 61,260	$ (16,221)	$ 752,151
Dispensing revenue				90,597		90,597
Cost of care	(123,227)	(357,402)	(58,742)	(19,676)	16,221	(542,826)
Cost of goods sold				(84,979)		(84,979)
Direct service costs and other	(41,399)	(28,934)	(13,863)	(31,374)	(28,927)	(144,497)
Stock compensation expense(1)	133	267	457	380	3,365	4,602
Segment profit (loss)	$ 35,045	$ 28,790	$ 20,567	$ 16,208	$ (25,562)	$ 75,048

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

NOTE C Business Segment Information (Continued)

	Commercial	Public Sector	Radiology Benefits Management	Pharmacy Solutions	Corporate and Elimination	Consolidated
Six Months Ended June 30, 2012						
Managed care and other revenue	$ 358,751	$ 799,024	$ 165,683	$ 117,425	$ (37,826)	$ 1,403,057
Dispensing revenue				175,629		175,629
Cost of care	(223,019)	(699,425)	(108,284)	(34,221)	37,826	(1,027,123)
Cost of goods sold				(163,893)		(163,893)
Direct service costs and other	(84,818)	(43,901)	(27,068)	(55,967)	(65,168)	(276,922)
Stock compensation expense(1)	537	556	760	466	7,148	9,467
Segment profit (loss)	$ 51,451	$ 56,254	$ 31,091	$ 39,439	$ (58,020)	$ 120,215

	Commercial	Public Sector	Radiology Benefits Management	Pharmacy Solutions	Corporate and Elimination	Consolidated
Six Months Ended June 30, 2013						
Managed care and other revenue	$ 387,375	$ 821,479	$ 182,993	$ 119,410	$ (31,466)	$ 1,479,791
Dispensing revenue				184,718		184,718
Cost of care	(236,498)	(712,781)	(116,809)	(38,135)	31,466	(1,072,757)
Cost of goods sold				(173,587)		(173,587)
Direct service costs and other	(82,791)	(54,577)	(27,234)	(60,935)	(58,587)	(284,124)
Stock compensation expense(1)	266	574	891	700	7,809	10,240
Segment profit (loss)	$ 68,352	$ 54,695	$ 39,841	$ 32,171	$ (50,778)	$ 144,281

(1) Stock compensation expense is included in direct service costs and other operating expenses, however this amount is excluded from the computation of Segment Profit since it is managed on a consolidated basis.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

NOTE C Business Segment Information (Continued)

The following table reconciles Segment Profit to income before income taxes (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	**2013**	**2012**	**2013**
Segment profit	$ 64,820	$ 75,048	$ 120,215	$ 144,281
Stock				