

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

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[TABLE OF CONTENTS](#)

[Table of Contents](#)

**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 June 30, 2013

Or

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

**For the transition period from _____ to _____
Commission File No. 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 No

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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 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 Smaller reporting company

(Do not check if a
smaller reporting company)

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

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

Table of Contents

FORM 10-Q

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

INDEX

| | Page No. |
|---|-----------------|
| <u>PART I Financial Information:</u> | |
| <u>Item 1:</u> <u>Financial Statements</u> | <u>3</u> |
| <u>Consolidated Balance Sheets December 31, 2012 and June 30, 2013</u> | <u>3</u> |
| <u>Consolidated Statements of Comprehensive Income For the Three Months and Six Months Ended June 30, 2012 and 2013</u> | <u>4</u> |
| <u>Consolidated Statements of Cash Flows For the Six Months Ended June 30, 2012 and 2013</u> | <u>5</u> |
| <u>Notes to Consolidated Financial Statements</u> | <u>6</u> |
| <u>Item 2:</u> <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | <u>26</u> |
| <u>Item 3:</u> <u>Quantitative and Qualitative Disclosures about Market Risk</u> | <u>44</u> |
| <u>Item 4:</u> <u>Controls and Procedures</u> | <u>44</u> |
| <u>PART II Other Information:</u> | |
| <u>Item 1:</u> <u>Legal Proceedings</u> | <u>45</u> |
| <u>Item 1A:</u> <u>Risk Factors</u> | <u>45</u> |
| <u>Item 2:</u> <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | <u>45</u> |
| <u>Item 3:</u> <u>Defaults Upon Senior Securities</u> | <u>46</u> |
| <u>Item 4:</u> <u>Mine Safety Disclosures</u> | <u>46</u> |
| <u>Item 5:</u> <u>Other Information</u> | <u>46</u> |
| <u>Item 6:</u> <u>Exhibits</u> | <u>47</u> |
| <u>Signatures</u> | <u>48</u> |

Table of Contents**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 | 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 | none |

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| | | |
|---|------------------|------------------|
| 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.

Table of Contents

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(In thousands, except per share amounts)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|------------------|------------------------------|------------------|
| | 2012 | 2013 | 2012 | 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.

Table of Contents

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) | (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 activities: | | |
| Property and equipment acquired under capital leases | \$ | \$ 29,323 |

See accompanying notes to consolidated financial statements.

Table of Contents

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,

Table of Contents

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.

Table of Contents

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

Table of Contents

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

Table of Contents

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

Table of Contents

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.

Table of Contents

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 it 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.

Table of Contents

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.

Table of Contents**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.

Table of Contents

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):

| | Amortized Cost | December 31, 2012 | | Estimated Fair Value |
|--|-------------------|------------------------------|-------------------------------|-------------------------|
| | | Gross Unrealized Gains | Gross Unrealized Losses | |
| 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 |

| | Amortized Cost | June 30, 2013 | | Estimated Fair Value |
|--|-------------------|------------------------------|-------------------------------|-------------------------|
| | | Gross Unrealized Gains | Gross Unrealized Losses | |
| 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.

Table of Contents**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,

Table of Contents**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.

Table of Contents**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.

Table of Contents

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 |

Table of Contents

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.

Table of Contents

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 |

Table of Contents

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.

Table of Contents**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 compensation expense | (4,365) | (4,602) | (9,467) | (10,240) |
| 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 |
| Income before income taxes | \$ 45,584 | \$ 53,066 | \$ 80,908 | \$ 100,234 |

NOTE D Commitments and Contingencies*Legal*

The management and administration of the delivery of specialty managed healthcare entails significant risks of liability. From time to time, the Company is subject to various actions and claims arising from the acts or omissions of its employees, network providers or other parties. In the normal course of business, the Company receives reports relating to deaths and other serious incidents involving patients whose care is being managed by the Company. Such incidents occasionally give rise to malpractice, professional negligence and other related actions and claims against the Company or its network providers. Many of these actions and claims received by the Company seek substantial damages and therefore require the Company to incur significant fees and costs related to their defense.

On July 25, 2012, the Company filed a lawsuit currently pending in the United States District Court for the District of Connecticut against two former employees and a corporation partially-owned by one of such former employees asserting claims for violation of contractual restrictive covenants and common law obligations owed to the Company arising from actions of such former employees in connection with their employment by the defendant corporation. The Company's complaint alleges claims for breach of contract and breach of the covenant of good dealing against the individual former employees; tortious interference with contract against the defendant corporation; and violation of the Connecticut Uniform Trade Secrets Act, civil conspiracy, and violation of the Connecticut Unfair Trade Practices Act against all defendants arising out of activity undertaken by the former employees on behalf of the defendant corporation in competition with the Company's specialty pharmacy business. The Company is seeking a permanent injunction and recovery of compensatory and punitive damages and an award of attorneys' fees and costs. On December 18, 2012, the defendant corporation filed counterclaims against the Company in which it asserts tortious interference with business expectancy, abuse of process, and violation of the Connecticut Unfair Trade Practices Act arising out of the Company's efforts to enforce its contractual and legal rights. On June 10, 2013, the defendant corporation disclosed an alleged damages computation in the amount of \$155 million in lost profits plus unspecified business diminution damages. The Company believes the counterclaims and damages calculations of the defendant corporation are without merit and is defending them vigorously.

Table of Contents

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

NOTE D Commitments and Contingencies (Continued)

The Company is also subject to or party to certain class actions and other litigation and claims relating to its operations or business practices. In the opinion of management, the Company has recorded reserves that are adequate to cover litigation, claims or assessments that have been or may be asserted against the Company, and for which the outcome is probable and reasonably estimable. Management believes that the resolution of such litigation and claims will not have a material adverse effect on the Company's financial condition or results of operations; however, there can be no assurance in this regard.

Stock Repurchases

On October 25, 2011 the Company's board of directors approved a stock repurchase plan which authorized the Company to purchase up to \$200 million of its outstanding common stock through October 25, 2013.

Stock repurchases under the program may be purchased from time to time in open market transactions (including blocks) or in privately negotiated transactions. The timing of repurchases and the actual amount purchased will depend on a variety of factors including the market price of the Company's shares, general market and economic conditions, and other corporate considerations. Repurchases may be made pursuant to plans intended to comply with Rule 10b5-1 under the Securities Exchange Act of 1934, which could allow the Company to purchase its shares during periods when it otherwise might be prevented from doing so under insider trading laws or because of self-imposed trading blackout periods. Repurchases are expected to be funded from working capital and anticipated cash from operations. The repurchase authorization does not require the purchase of a specific number of shares and is subject to suspension or termination by the Company's board of directors at any time. Pursuant to this program, the Company made open market purchases of 671,776 shares of the Company's common stock at an average price of \$48.72 per share for an aggregate cost of \$32.7 million (excluding broker commissions) during the period from November 11, 2011 through December 31, 2011. Pursuant to this program, the Company made open market purchases of 459,252 shares of the Company's common stock at an average price of \$50.27 per share for an aggregate cost of \$23.1 million (excluding broker commissions) during 2012. Pursuant to this program, the Company made open market purchases of 955,776 shares of the Company's common stock at an average price of \$50.23 per share for an aggregate cost of \$48.0 million (excluding broker commissions) during the six months ended June 30, 2013. As of June 30, 2013, the total dollar value remaining under the current authorization was \$96.2 million.

The Company made no open market purchases for the period from July 1, 2013 through July 24, 2013.

NOTE E Subsequent Event

On July 24, 2013 the Company's board of directors approved an increase and extension of the current \$200 million stock repurchase plan which authorizes the Company to purchase up to \$300 million of its outstanding common stock through October 25, 2015. As of July 24, 2013, the total dollar value remaining under the increased authorization was \$196.2 million. The shares may be

Table of Contents

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

NOTE E Subsequent Event (Continued)

purchased from time to time in open market transactions (including blocks) or in privately negotiated transactions. The timing of repurchases and the actual amount purchased will depend on a variety of factors including the market price of the Company's shares, general market and economic conditions, and other corporate considerations. Repurchases may be made pursuant to plans intended to comply with Rule 10b5-1 under the Securities Exchange Act of 1934, which could allow the Company to purchase its shares during periods when it otherwise might be prevented from doing so under insider trading laws or because of self-imposed trading blackout periods. Repurchases are expected to be funded from working capital and anticipated cash from operations. The repurchase authorization does not require the purchase of a specific number of shares and is subject to suspension or termination by the Company's board of directors at any time.

Table of Contents

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion and analysis of the financial condition and results of operations of Magellan and its majority-owned subsidiaries and all VIEs for which Magellan is the primary beneficiary should be read together with the Consolidated Financial Statements and the notes to the Consolidated Financial Statements included elsewhere in this Quarterly Report on Form 10-Q and the Company's Annual Report on Form 10-K for the year ended December 31, 2012, which was filed with the SEC on February 28, 2013.

Forward-Looking Statements

This Form 10-Q includes "forward-looking statements" within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act. Although the Company believes that its plans, intentions and expectations as reflected in such forward-looking statements are reasonable, it can give no assurance that such plans, intentions or expectations will be achieved. Prospective investors are cautioned that any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties, and that actual results may differ materially from those contemplated by such forward-looking statements. Important factors currently known to management that could cause actual results to differ materially from those in forward-looking statements include:

the Company's inability to renegotiate or extend expiring customer contracts, or the termination of customer contracts;

the Company's inability to integrate acquisitions in a timely and effective manner;

changes in business practices of the industry, including the possibility that certain of the Company's managed care customers could seek to provide managed healthcare services directly to their subscribers, instead of contracting with the Company for such services, particularly as a result of further consolidation in the managed care industry and especially regarding managed healthcare customers that have already done so with a portion of their membership;

the impact of changes in the contracting model for Medicaid contracts, including certain changes in the contracting model used by states for managed healthcare services contracts relating to Medicaid lives;

the Company's ability to accurately predict and control healthcare costs, and to properly price the Company's services;

the Company's ability to accurately underwrite and control healthcare costs associated with its expansion into clinically integrated management of special populations eligible for Medicaid and Medicare, including individuals with SMI and other unique high-cost populations;

the Company's ability to maintain or secure cost-effective healthcare provider contracts;

fluctuation in quarterly operating results due to seasonal and other factors;

the Company's dependence on government spending for managed healthcare, including changes in federal, state and local healthcare policies;

restrictive covenants in the Company's debt instruments;

present or future state regulations and contractual requirements that the Company provide financial assurance of its ability to meet its obligations;

the impact of the competitive environment in the managed healthcare services industry which may limit the Company's ability to maintain or obtain contracts, as well as its ability to maintain or increase its rates;

Table of Contents

the impact of healthcare reform legislation;

the Mental Health and Substance Abuse Benefit Parity Law and Regulations;

government regulation;

the unauthorized disclosure of sensitive or confidential member or other information;

the possible impact of additional regulatory scrutiny and liability associated with the Company's Pharmacy Solutions segment;

the inability to realize the value of goodwill and intangible assets;

pending or future actions or claims for professional liability;

claims brought against the Company that either exceed the scope of the Company's liability coverage or result in denial of coverage;

class action suits and other legal proceedings;

negative publicity;

the impact of governmental investigations;

the impact of varying economic and market conditions on the Company's investment portfolio; and

the state of the national economy and adverse changes in economic conditions.

Further discussion of factors currently known to management that could cause actual results to differ materially from those in forward-looking statements is set forth under the heading "Risk Factors" in Item 1A of Magellan's Annual Report on Form 10-K for the year ended December 31, 2012. When used in this Quarterly Report on Form 10-Q, the words "estimate," "anticipate," "expect," "believe," "should," and similar expressions are intended to be forward-looking statements. Magellan undertakes no obligation to update or revise forward-looking statements to reflect changed assumptions, the occurrence of unanticipated events or changes to future operating results over time, except as required by law.

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

Table of Contents

services. The Company generally does not directly provide or own any provider of treatment services, 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) 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) 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. 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. As of June 30, 2013, Commercial's covered lives were 4.9 million, 13.5 million and 12.6 million for risk-based, ASO and EAP products, respectively. For the six months ended June 30, 2013, Commercial's revenue was \$257.4 million, \$61.0 million and \$69.0 million for risk-based, ASO and EAP products, respectively.

Public Sector. 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. As of June 30, 2013, Public Sector's covered lives were 1.9 million and 1.1 million for risk-based and ASO products, respectively. For the six months ended June 30, 2013, Public Sector's revenue was \$805.1 million and \$16.4 million for risk-based and ASO products, respectively.

Radiology Benefits Management

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. As of June 30, 2013, covered lives for Radiology Benefits Management were 5.1 million and 12.3 million for risk-based and ASO products, respectively. For the six months ended June 30, 2013, revenue for Radiology Benefits Management was \$163.2 million and \$19.8 million for risk-based and ASO products, respectively.

Pharmacy Solutions

Pharmacy Solutions comprises products and solutions that provide clinical and financial management of drugs paid under medical and pharmacy benefit programs. The Company's Pharmacy Solutions services include (i) pharmacy benefit management programs; (ii) specialty contracting and formulary optimization programs; (iii) specialty pharmaceutical dispensing operations; (iv) medical

Table of Contents

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 FFS arrangements. The Company's Pharmacy Solutions segment served 40 health plans and employers, 25 states and the District of Columbia, and several pharmaceutical manufacturers as of June 30, 2013.

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.

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 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

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Table of Contents

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. In the event that the Company does not prevail on the Appeal, the Company will likely incur shutdown costs pertaining to the contract, including severance and lease termination charges. As of June 30, 2013, the Company has not accrued any such shutdown costs, which are not estimated to be material.

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 it 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.

Table of Contents

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.

Critical Accounting Policies and 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. Except as noted below, the Company's critical accounting policies are summarized in the Company's Annual Report on Form 10-K, filed with the SEC on February 28, 2013.

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. Further, it is reasonably possible the statutes of limitation regarding the assessment of federal and certain state and local income taxes for 2009 will expire during 2013.

Results of Operations

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 Segment Profit.

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Table of Contents

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.

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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Table of Contents

| | 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.

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 compensation expense | (4,365) | (4,602) | (9,467) | (10,240) |
| 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 |
| Income before income taxes | \$ 45,584 | \$ 53,066 | \$ 80,908 | \$ 100,234 |

Table of Contents

Quarter ended June 30, 2013 ("Current Year Quarter"), compared to the quarter ended June 30, 2012 ("Prior Year Quarter")

Commercial

Net Revenue

Net revenue related to Commercial increased by 12.0 percent or \$21.3 million from the Prior Year Quarter to the Current Year Quarter. The increase in revenue is mainly due to new contracts implemented after (or during) the Prior Year Quarter of \$15.3 million, favorable rate changes of \$9.1 million, customer settlements in the Current Year Quarter of \$6.7 million, and increased membership from existing customers of \$6.8 million, which increases were partially offset by terminated contracts of \$12.3 million, recognition in the Prior Year Quarter of performance-based revenue of \$2.3 million, and other net decreases of \$2.0 million.

Cost of Care

Cost of care increased by 11.2 percent or \$12.4 million from the Prior Year Quarter to the Current Year Quarter. The increase in cost of care is primarily due to new contracts of \$9.9 million, membership from existing customers of \$4.8 million, favorable prior period medical claims development recorded in the Prior Year Quarter of \$1.0 million and unfavorable care trends and other net variances of \$10.7 million, which increases were partially offset by terminated contracts of \$9.6 million and favorable medical claims development for the Prior Year Quarter which was recorded after the Prior Year Quarter of \$4.4 million. Cost of care increased as a percentage of risk revenue (excluding EAP business) from 80.4 percent in the Prior Year Quarter to 81.4 percent in the Current Year Quarter, mainly due to unfavorable care trends in excess of favorable rate changes.

Direct Service Costs

Direct service costs decreased by 2.5 percent or \$1.1 million from the Prior Year Quarter to the Current Year Quarter mainly due to cost containment efforts. Direct service costs decreased as a percentage of revenue from 23.8 percent in the Prior Year Quarter to 20.7 percent in the Current Year Quarter, mainly due to favorable rate changes and changes in business mix.

Public Sector

Net Revenue

Net revenue related to Public Sector increased by 1.2 percent or \$4.7 million from the Prior Year Quarter to the Current Year Quarter. This increase is primarily due to new contracts implemented after the Prior Year Quarter of \$8.2 million and other net favorable variances of \$0.2 million, which were partially offset by unfavorable rate changes of \$2.3 million and decreased membership from existing customers of \$1.4 million.

Cost of Care

Cost of care increased by 0.6 percent or \$2.3 million from the Prior Year Quarter to the Current Year Quarter. This increase is primarily due to new contracts of \$7.7 million, favorable contractual settlements of \$2.2 million in the Prior Year Quarter, and unfavorable care trends and other net variances of \$2.0 million, which increases were partially offset by favorable prior period care development recorded in the Current Year Quarter of \$6.2 million, care associated with rate changes for contracts with minimum care requirements of \$1.8 million, and decreased membership from existing customers of \$1.6 million. Cost of care decreased as a percentage of risk revenue from 88.3 percent in the Prior Year Quarter to 87.9 percent in the Current Year Quarter mainly due to changes in business mix.

Table of Contents

Direct Service Costs

Direct service costs increased by 24.2 percent or \$5.6 million from the Prior Year Quarter to the Current Year Quarter, mainly due to costs to support new business and development costs for the Magellan Complete Care product. Direct service costs increased as a percentage of revenue from 5.7 percent for the Prior Year Quarter to 7.0 percent in the Current Year Quarter mainly due to development costs for the Magellan Complete Care product.

Radiology Benefits Management

Net Revenue

Net revenue related to Radiology Benefits Management increased by 4.4 percent or \$3.9 million from the Prior Year Quarter to the Current Year Quarter. This increase is primarily due to new contracts implemented after (or during) the Prior Year Quarter of \$12.5 million, which increase was partially offset by favorable contractual settlements of \$4.4 million in the Prior Year Quarter, the revenue impact of favorable prior period care development recorded in the Current Year Quarter of \$1.8 million, unfavorable rate changes of \$1.7 million, and other net unfavorable variances of \$0.7 million.

Cost of Care

Cost of care increased by 1.5 percent or \$0.9 million from the Prior Year Quarter to the Current Year Quarter. This increase is primarily attributed to new contracts of \$9.3 million, which increase was partially offset by favorable prior period medical claims development recorded in the Current Year Quarter of \$4.1 million, favorable medical claims development for the Prior Year Quarter recorded after the Prior Year Quarter of \$1.4 million and care trends and other net favorable variances of \$2.9 million. Cost of care decreased as a percentage of risk revenue from 73.6 percent in the Prior Year Quarter to 70.7 percent in the Current Year Quarter mainly due to favorable medical claims development and favorable care trends.

Direct Service Costs

Direct service costs increased by 2.1 percent or \$0.3 million from the Prior Year Quarter to the Current Year Quarter mainly due to new business. As a percentage of revenue, direct service costs decreased from 15.3 percent in the Prior Year Quarter to 15.0 percent in the Current Year Quarter, mainly due to changes in business mix.

Pharmacy Solutions

Net Revenue

Net revenue related to Pharmacy Solutions increased by 4.7 percent or \$6.9 million from the Prior Year Quarter to the Current Year Quarter. This increase is primarily due to new business of \$5.9 million (mainly PBM), net increased dispensing activity from existing customers of \$3.0 million, and other net increases of \$0.9 million, which increases were partially offset by retroactive revenue adjustments recorded in the Prior Year Quarter of \$2.0 million and terminated contracts of \$0.9 million.

Cost of Care

Cost of care increased by 33.7 percent or \$5.0 million from the Prior Year Quarter to the Current Year Quarter. This increase is primarily due to new PBM business of \$5.2 million. Cost of care increased as a percentage of risk revenue from 88.0 percent in the Prior Year Quarter to 90.9 percent in the Current Year Quarter, mainly due to the impact of PBM new business.

Table of Contents

Cost of Goods Sold

Cost of goods sold increased by 2.6 percent or \$2.1 million from the Prior Year Quarter to the Current Year Quarter. This increase is primarily due to increased dispensing activity from existing customers. As a percentage of the portion of net revenue that relates to dispensing activity, cost of goods sold increased from 93.6 percent in the Prior Year Quarter to 93.8 percent in the Current Year Quarter, mainly due to business mix.

Direct Service Costs

Direct service costs increased by 16.4 percent or \$4.4 million from the Prior Year Quarter to the Current Year Quarter. This increase mainly relates to implementation costs and ongoing costs to support new business. As a percentage of revenue, direct service costs increased from 18.6 percent in the Prior Year Quarter to 20.7 percent in the Current Year Quarter, mainly due to implementation costs and ongoing costs to support new business.

Corporate and Other

Other Operating Expenses

Other operating expenses related to the Corporate and Other segment decreased by 15.0 percent or \$5.1 million from the Prior Year Quarter to the Current Year Quarter. The decrease results primary from expenses recorded in the Prior Year Quarter for growth initiatives. As a percentage of total net revenue, other operating expenses decreased from 4.2 percent for the Prior Year Quarter to 3.4 percent for the Current Year Quarter, primarily due to increased revenue from new business, as well as the inclusion in the Prior Year Quarter of expenses incurred to support growth initiatives.

Depreciation and Amortization

Depreciation and amortization expense increased by 11.8 percent or \$1.8 million from the Prior Year Quarter to the Current Year Quarter, primarily due to asset additions after the Prior Year Quarter.

Interest Expense

Interest expense increased by 37.5 percent or \$0.2 million from the Prior Year Quarter to the Current Year Quarter, mainly due to capital lease additions after the Prior Year Quarter.

Interest Income

Interest income decreased by 58.2 percent or \$0.5 million from the Prior Year Quarter to the Current Year Quarter, mainly due to lower yields on investments in Current Year Quarter.

Income Taxes

The Company's effective income tax rates were 40.8 percent and 40.7 percent for the Prior Year Quarter and Current Year Quarter, respectively. The effective income tax rate for the Current Year Quarter is lower than the Prior Year Quarter effective rate mainly due to differences in the Company's effective state tax rate.

Table of Contents

Six months ended June 30, 2013 ("Current Year Period"), compared to the six months ended June 30, 2012 ("Prior Year Period")

Commercial

Net Revenue

Net revenue related to Commercial increased by 8.0 percent or \$28.6 million from the Prior Year Period to the Current Year Period. The increase in revenue is mainly due to new contracts implemented after (or during) the Prior Year Period of \$30.9 million, favorable rate changes of \$22.8 million, customers settlements in the Current Year Period of \$6.7 million, and increased membership from existing customers of \$6.6 million, which increases were partially offset by terminated contracts of \$26.7 million, performance-based revenue recorded in the Prior Year Period of \$8.9 million, and other net decreases of \$2.8 million.

Cost of Care

Cost of care increased by 6.0 percent or \$13.5 million from the Prior Year Period to the Current Year Period. The increase in cost of care is primarily due to new contracts of \$20.8 million, increased membership from existing customers of \$3.7 million, favorable prior period medical claims development recorded in the Prior Year Period of \$2.7 million, and unfavorable care trends and other net variances of \$15.2 million, which increases were partially offset by terminated contracts of \$21.3 million, favorable prior period medical claims development recorded in the Current Year Period of \$4.4 million, and favorable medical claims development for the Prior Year Period which was recorded after the Prior Year Period of \$3.2 million. Cost of care decreased as a percentage of risk revenue (excluding EAP business) from 81.6 percent in the Prior Year Period to 79.0 percent in the Current Year Period, mainly due to favorable rate changes in excess of unfavorable care trends and business mix.

Direct Service Costs

Direct service costs decreased by 2.4 percent or \$2.0 million from the Prior Year Period to the Current Year Period mainly due to cost containment efforts. Direct service costs decreased as a percentage of revenue from 23.6 percent in the Prior Year Period to 21.4 percent in the Current Year Period, mainly due to cost containment efforts and the impact of increased revenue from favorable rate changes.

Public Sector

Net Revenue

Net revenue related to Public Sector increased by 2.8 percent or \$22.5 million from the Prior Year Period to the Current Year Period. This increase is primarily due to new contracts implemented after (or during) the Prior Year Period of \$41.6 million, which was partially offset by decreased membership from existing customers of \$9.9 million, unfavorable rate changes of \$9.1 million, and other net unfavorable variances of \$0.1 million.

Cost of Care

Cost of care increased by 1.9 percent or \$13.4 million from the Prior Year Period to the Current Year Period. This increase is primarily due to new contracts of \$33.0 million and favorable contractual settlements of \$2.2 million in the Prior Year Period, which increases were partially offset by decreased membership from existing customers of \$9.9 million, favorable prior period medical claims development recorded in the Current Year Period of \$7.8 million, care associated with rate changes for contracts with minimum care requirements of \$4.0 million, and other net favorable variances of \$0.1 million.

Table of Contents

Cost of care decreased as a percentage of risk revenue from 88.8 percent in the Prior Year Period to 88.5 percent in the Current Year Period mainly due to changes in business mix.

Direct Service Costs

Direct service costs increased by 24.3 percent or \$10.7 million from the Prior Year Period to the Current Year Period, mainly due to costs to support new business and development costs for the Magellan Complete Care product. Direct service costs increased as a percentage of revenue from 5.5 percent for the Prior Year Period to 6.6 percent in the Current Year Period mainly due to development costs for the Magellan Complete Care product.

Radiology Benefits Management

Net Revenue

Net revenue related to Radiology Benefits Management increased by 10.4 percent or \$17.3 million from the Prior Year Period to the Current Year Period. This increase is primarily due to new contracts implemented after (or during) the Prior Year Period of \$26.3 million and increased membership from existing customers of \$2.2 million, which increases were partially offset by contractual settlements of \$4.4 million in the Prior Year Period, the revenue impact of favorable prior period care development recorded in the Current Year Period of \$2.0 million, unfavorable rate changes of \$2.6 million, and other net unfavorable variances of \$2.2 million.

Cost of Care

Cost of care increased by 7.9 percent or \$8.5 million from the Prior Year Period to the Current Year Period. This increase is primarily attributed to new contracts of \$21.1 million, which increase was partially offset by favorable prior period medical claims development recorded in the Current Year Period of \$5.0 million, favorable medical claims development for the Prior Year Period recorded after the Prior Year Period of \$3.1 million, and care trends and other net favorable variances of \$4.5 million. Cost of care decreased as a percentage of risk revenue from 74.7 percent in the Prior Year Period to 71.6 percent in the Current Year Period mainly due to favorable medical claims development and care trends.

Direct Service Costs

Direct service costs increased by 0.6 percent or \$0.2 million from the Prior Year Period to the Current Year Period. As a percentage of revenue, direct service costs decreased from 16.3 percent in the Prior Year Period to 14.9 percent in the Current Year Period, mainly due to changes in business mix.

Pharmacy Solutions

Net Revenue

Net revenue related to Pharmacy Solutions increased by 3.8 percent or \$11.1 million from the Prior Year Period to the Current Year Period. This increase is primarily due to new business of \$11.0 million (mainly PBM) and net increased dispensing activity from existing customers of \$12.9 million, which increases were partially offset by a reduction to revenue associated with profit share recorded due to favorable cost of care trends of \$6.4 million, terminated contracts of \$5.4 million, and retroactive revenue adjustments recorded in the Prior Year Period of \$1.0 million.

Table of Contents

Cost of Care

Cost of care increased by 11.4 percent or \$3.9 million from the Prior Year Period to the Current Year Period. This increase is primarily due to new PBM business of \$10.1 million, which increase was partially offset by favorable care trends of \$6.2 million. Cost of care increased as a percentage of risk revenue from 90.5 percent in the Prior Year Period to 90.9 percent in the Current Year Period, mainly due to business mix.

Cost of Goods Sold

Cost of goods sold increased by 5.9 percent or \$9.7 million from the Prior Year Period to the Current Year Period. This increase is primarily due to increased dispensing activity of \$13.2 million and other net favorable activity of \$0.3 million, which increases were partially offset by terminated contracts of \$3.8 million. As a percentage of the portion of net revenue that relates to dispensing activity, cost of goods sold increased from 93.3 percent in the Prior Year Period to 94.0 percent in the Current Year Period, mainly due to business mix.

Direct Service Costs

Direct service costs increased by 8.9 percent or \$5.0 million from the Prior Year Period to the Current Year Period. This increase mainly relates to implementation costs and ongoing costs to support new business. As a percentage of revenue, direct service costs decreased from 19.1 percent in the Prior Year Period to 20.0 percent in the Current Year Period, mainly due to implementation costs and ongoing costs to support new business.

Corporate and Other

Other Operating Expenses

Other operating expenses related to the Corporate and Other segment decreased by 10.1 percent or \$6.6 million from the Prior Year Period to the Current Year Period. The decrease results primary from expenses recorded in the Prior Year Period for growth initiatives. As a percentage of total net revenue, other operating expenses decreased from 4.1 percent for the Prior Year Period to 3.5 percent for the Current Year Period, primarily due to increased revenue from new business, as well as the inclusion in the Prior Year Period of expenses incurred to support growth initiatives.

Depreciation and Amortization

Depreciation and amortization expense increased by 10.6 percent or \$3.2 million from the Prior Year Period to the Current Year Period, primarily due to asset additions after the Prior Year Period.

Interest Expense

Interest expense increased by 19.2 percent or \$0.2 million from the Prior Year Period to the Current Year Period, primarily due to capital leases additions after the Prior Year Period.

Interest Income

Interest income decreased by 44.0 percent or \$0.6 million from the Prior Year Period to the Current Year Period, primarily due to lower yields on investments in the Current Year Period.

Income Taxes

The Company's effective income tax rates were 41.0 percent and 40.6 percent for the Prior Year Period and Current Year Period, respectively. The effective income tax rate for the Current Year Period

Table of Contents

is lower than the Prior Year Period effective rate mainly due to differences in the Company's effective state tax rate.

Outlook Results of Operations

The Company's Segment Profit and net income are subject to significant fluctuations from period to period. These fluctuations may result from a variety of factors such as those set forth under Item 2 "Forward-Looking Statements" as well as a variety of other factors including: (i) changes in utilization levels by enrolled members of the Company's risk-based contracts, including seasonal utilization patterns; (ii) contractual adjustments and settlements; (iii) retrospective membership adjustments; (iv) timing of implementation of new contracts, enrollment changes and contract terminations; (v) pricing adjustments upon contract renewals (and price competition in general); and (vi) changes in estimates regarding medical costs and IBNR.

A portion of the Company's business is subject to rising care costs due to an increase in the number and frequency of covered members seeking behavioral healthcare or radiology services, higher costs per inpatient day or outpatient visit for behavioral services, and higher costs per scan for radiology services. Many of these factors are beyond the Company's control. Future results of operations will be heavily dependent on management's ability to obtain customer rate increases that are consistent with care cost increases and/or to reduce operating expenses.

In relation to the managed behavioral healthcare business, the Company is a market leader in a mature market with many viable competitors. The Company is continuing its attempts to grow its business in the managed behavioral healthcare industry through aggressive marketing and development of new products; however, due to the maturity of the market, the Company believes that the ability to grow its current business lines may be limited. In addition, as previously discussed, substantially all of the Company's Commercial segment revenues are derived from Blue Cross Blue Shield health plans and other managed care companies, health insurers and health plans. In the past, certain of the managed care customers of the Company have decided not to renew all or part of their contracts with the Company, and to instead manage the behavioral healthcare services directly for their subscribers.

Care Trends. The Company expects that same-store normalized cost of care trend for the 12-month forward outlook to be 6 to 8 percent for Commercial, 0 to 2 percent for Public Sector and 3 to 5 percent for Radiology Benefits Management.

Interest Rate Risk. Changes in interest rates affect interest income earned on the Company's cash equivalents and investments, as well as interest expense on variable interest rate borrowings under the Company's 2011 Credit Facility. Based on the amount of cash equivalents and investments and the borrowing levels under the 2011 Credit Facility as of June 30, 2013, a hypothetical 10 percent increase or decrease in the interest rate associated with these instruments, with all other variables held constant, would not materially affect the Company's future earnings and cash outflows.

Historical Liquidity and Capital Resources

Operating Activities. The Company reported net cash provided by operating activities of \$75.0 million and \$86.9 million for the Prior Year Period and Current Year Period, respectively. The \$11.9 million increase in operating cash flows from the Prior Year Period to the Current Year Period is primarily attributable to the increase in Segment Profit between periods and the impact of the net shift of restricted funds between cash and investments that results in an operating cash flow change that is directly offset by an investing cash flow change. Partially offsetting these items is the increase in tax payments and the net unfavorable impact of working capital changes between periods.

Segment Profit for the Current Year Period increased \$24.1 million from the Prior Year Period. During the Prior Year Period, restricted investments of \$19.5 million were shifted to restricted cash that

Table of Contents

reduced operating cash flows, with restricted cash of \$31.2 million shifted to restricted investments during the Current Year Period that increased operating cash flows. The net impact of the shift in restricted funds between periods is an increase in operating cash flows of \$50.7 million. Tax payments for the Current Year Period totaled \$41.6 million, which represents an increase of \$14.2 million from the Prior Year Period. The net unfavorable impact of working capital changes between periods totaled \$48.7 million, and is largely attributable to increases in management incentive payments, accounts receivable and pharmaceutical inventory levels, as well as a net increase in restricted cash requirements associated with the Company's regulated entities.

During the Current Year Period, the Company's restricted cash decreased \$37.1 million. The change in restricted cash is attributable to the net shift of restricted cash to restricted investments of \$31.2 million and a reduction in restricted cash of \$6.5 million associated with the Company's regulated entities, partially offset by other net increases of \$0.6 million. The net change in restricted cash for the Company's regulated entities is attributable to a net reduction in restricted cash of \$18.7 million that is offset by changes in other assets and liabilities, primarily accounts receivable, accrued liabilities, medical claims payable and other medical liabilities, thus having no impact on operating cash flows, and a net increase of \$12.2 million in restricted cash requirements that resulted in an operating cash flow use.

Investing Activities. The Company utilized \$36.9 million and \$27.0 million during the Prior Year Period and Current Year Period, respectively, for capital expenditures. The additions related to hard assets (equipment, furniture, leaseholds) and capitalized software for the Prior Year Period were \$20.2 million and \$16.7 million, respectively, as compared to additions for the Current Year Period related to hard assets and capitalized software of \$7.9 million and \$19.1 million, respectively. During the Prior Year Period the Company received net cash of \$7.7 million for the net maturity of "available for sale" securities, with the Company using net cash of \$26.3 million during the Current Year Period for the net purchase of "available-for-sale" securities. In addition, during the Current Year Period 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.

Financing Activities. During the Prior Year Period, the Company received \$3.0 million from the exercise of stock options and had other net unfavorable items of \$0.7 million.

During the Current Year Period, the Company paid \$49.5 million for the repurchase of treasury stock under the Company's share repurchase program, paid \$1.8 million on capital lease obligations, and had other net unfavorable items of \$0.7 million. In addition, the Company received \$16.1 million from the exercise of stock options.

Outlook Liquidity and Capital Resources

Liquidity. During the remainder of 2013, the Company expects to fund its estimated capital expenditures of \$25 million to \$35 million with cash from operations. The Company does not anticipate that it will need to draw on amounts available under the 2011 Credit Facility for cash flow needs related to its operations, capital needs or debt service in 2013. The Company also currently expects to have adequate liquidity to satisfy its existing financial commitments over the periods in which they will become due. The Company plans to maintain its current investment strategy of investing in a diversified, high quality, liquid portfolio of investments and continues to closely monitor the situation in the financial markets. The Company estimates that it has no risk of any material permanent loss on its investment portfolio; however, there can be no assurance that the Company will not experience any such losses in the future.

Table of Contents

Stock Repurchases. On October 25, 2011 the Company's board of directors approved a stock repurchase plan which authorized the Company to purchase up to \$200 million of its outstanding common stock through October 25, 2013.

Stock repurchases under the program may be purchased from time to time in open market transactions (including blocks) or in privately negotiated transactions. The timing of repurchases and the actual amount purchased will depend on a variety of factors including the market price of the Company's shares, general market and economic conditions, and other corporate considerations. Repurchases may be made pursuant to plans intended to comply with Rule 10b5-1 under the Securities Exchange Act of 1934, which could allow the Company to purchase its shares during periods when it otherwise might be prevented from doing so under insider trading laws or because of self-imposed trading blackout periods. Repurchases are expected to be funded from working capital and anticipated cash from operations. The repurchase authorization does not require the purchase of a specific number of shares and is subject to suspension or termination by the Company's board of directors at any time. Pursuant to this program, the Company made open market purchases of 671,776 shares of the Company's common stock at an average price of \$48.72 per share for an aggregate cost of \$32.7 million (excluding broker commissions) during the period from November 11, 2011 through December 31, 2011. Pursuant to this program, the Company made open market purchases of 459,252 shares of the Company's common stock at an average price of \$50.27 per share for an aggregate cost of \$23.1 million (excluding broker commissions) during 2012. Pursuant to this program, the Company made open market purchases of 955,776 shares of the Company's common stock at an average price of \$50.23 per share for an aggregate cost of \$48.0 million (excluding broker commissions) during the six months ended June 30, 2013. As of June 30, 2013, the total dollar value remaining under the current authorization was \$96.2 million.

The Company made no open market purchases for the period from July 1, 2013 through July 24, 2013.

Off-Balance Sheet Arrangements. As of June 30, 2013, the Company has no material off-balance sheet arrangements.

2011 Credit Facility. 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.

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.

Table of Contents

Restrictive Covenants in Debt Agreements. The 2011 Credit Facility contains covenants that limit management's discretion in operating the Company's business by restricting or limiting the Company's ability, among other things, to:

incur or guarantee additional indebtedness or issue preferred or redeemable stock;

pay dividends and make other distributions;

repurchase equity interests;

make certain advances, investments and loans;

enter into sale and leaseback transactions;

create liens;

sell and otherwise dispose of assets;

acquire or merge or consolidate with another company; and

enter into some types of transactions with affiliates.

These restrictions could adversely affect the Company's ability to finance future operations or capital needs or engage in other business activities that may be in the Company's interest.

The 2011 Credit Facility also requires the Company to comply with specified financial ratios and tests. Failure to do so, unless waived by the lenders under the 2011 Credit Facility pursuant to its terms, would result in an event of default under the 2011 Credit Facility. As of June 30, 2013, the Company was in compliance with all covenants, including financial covenants, under the 2011 Credit Facility.

Although the 2011 Credit Facility expires on December 9, 2014, the Company believes it will be able to obtain a new facility or, if not, to use cash on hand to fund letters of credit and other liquidity needs.

Net Operating Loss Carryforwards. The Company had federal net operating loss carryforwards ("NOLs") as of December 31, 2012 of approximately \$4.2 million available to reduce future federal taxable income. These NOLs, if not used, expire in 2017 through 2019 and are subject to examination and adjustment by the IRS. Utilization of these NOLs is also subject to certain timing limitations, although the Company does not believe these limitations will restrict its ability to use any federal NOLs before they expire.

As of December 31, 2012, the Company's valuation allowances against deferred tax assets were \$3.1 million, mostly relating to uncertainties regarding the eventual realization of certain state NOLs. Determination of the amount of deferred tax assets considered realizable requires significant judgment and estimation regarding the forecasts of future taxable income which are consistent with the plans and estimates the Company uses to manage the underlying businesses. Future changes in the estimated realizable portion of deferred taxes could materially affect the Company's financial condition and results of operations.

Recent Accounting Pronouncements

In October 2012, the FASB issued ASU 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

Table of Contents

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 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 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.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Changes in interest rates affect interest income earned on the Company's cash equivalents and investments, as well as interest expense on variable interest rate borrowings under the Company's 2011 Credit Facility. Based on the amount of cash equivalents and investments and the borrowing levels under the 2011 Credit Facility as of June 30, 2013, a hypothetical 10 percent increase or decrease in the interest rate associated with these instruments, with all other variables held constant, would not materially affect the Company's future earnings and cash outflows.

Item 4. Controls and Procedures.

a) The Company's management evaluated, with the participation of the Company's principal executive and principal financial officers, the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) under the Exchange Act), as of June 30, 2013. Based on their evaluation, the Company's principal executive and principal financial officers concluded that the Company's disclosure controls and procedures were effective as of June 30, 2013.

b) Under the supervision and with the participation of management, including the Company's principal executive and principal financial officers, the Company has determined that there has been no change in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that occurred during the Company's quarter ended June 30, 2013 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Table of Contents

PART II OTHER INFORMATION

Item 1. Legal Proceedings.

The management and administration of the delivery of specialty managed healthcare entails significant risks of liability. From time to time, the Company is subject to various actions and claims arising from the acts or omissions of its employees, network providers or other parties. In the normal course of business, the Company receives reports relating to deaths and other serious incidents involving patients whose care is being managed by the Company. Such incidents occasionally give rise to malpractice, professional negligence and other related actions and claims against the Company or its network providers. Many of these actions and claims received by the Company seek substantial damages and therefore require the Company to incur significant fees and costs related to their defense.

On July 25, 2012, the Company filed a lawsuit currently pending in the United States District Court for the District of Connecticut against two former employees and a corporation partially-owned by one of such former employees asserting claims for violation of contractual restrictive covenants and common law obligations owed to the Company arising from actions of such former employees in connection with their employment by the defendant corporation. The Company's complaint alleges claims for breach of contract and breach of the covenant of good dealing against the individual former employees; tortious interference with contract against the defendant corporation; and violation of the Connecticut Uniform Trade Secrets Act, civil conspiracy, and violation of the Connecticut Unfair Trade Practices Act against all defendants arising out of activity undertaken by the former employees on behalf of the defendant corporation in competition with the Company's specialty pharmacy business. The Company is seeking a permanent injunction and recovery of compensatory and punitive damages and an award of attorneys' fees and costs. On December 18, 2012, the defendant corporation filed counterclaims against the Company in which it asserts tortious interference with business expectancy, abuse of process, and violation of the Connecticut Unfair Trade Practices Act arising out of the Company's efforts to enforce its contractual and legal rights. On June 10, 2013, the defendant corporation disclosed an alleged damages computation in the amount of \$155 million in lost profits plus unspecified business diminution damages. The Company believes the counterclaims and damages calculations of the defendant corporation are without merit and is defending them vigorously.

The Company is also subject to or party to certain class actions and other litigation and claims relating to its operations or business practices. In the opinion of management, the Company has recorded reserves that are adequate to cover litigation, claims or assessments that have been or may be asserted against the Company, and for which the outcome is probable and reasonably estimable. Management believes that the resolution of such litigation and claims will not have a material adverse effect on the Company's financial condition or results of operations; however, there can be no assurance in this regard.

Item 1A. Risk Factors.

There has been no material change in our risk factors as disclosed in Part I Item 1A "Risk Factors" of the Company's Annual Report on Form 10-K for the year ended December 31, 2012 which was filed with the SEC on February 28, 2013.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

The Company's board of directors has previously authorized a series of stock repurchase plans. Stock repurchases for each such plan could be executed through open market repurchases, privately negotiated transactions, accelerated share repurchases or other means. The board of directors authorized management to execute stock repurchase transactions from time to time and in such amounts and via such methods as management deemed appropriate. Each stock repurchase program could be limited or terminated at any time without prior notice.

Table of Contents

On October 25, 2011 the Company's board of directors approved a stock repurchase plan which authorized the Company to purchase up to \$200 million of its outstanding common stock through October 25, 2013. Pursuant to this program, the Company made open market purchases of 671,776 shares of the Company's common stock at an average price of \$48.72 per share for an aggregate cost of \$32.7 million (excluding broker commissions) during the period from November 11, 2011 through December 31, 2011. Pursuant to this program, the Company made open market purchases of 459,252 shares of the Company's common stock at an average price of \$50.27 per share for an aggregate cost of \$23.1 million (excluding broker commissions) during 2012. Pursuant to this program, the Company made open market purchases of 955,776 shares of the Company's common stock at an average price of \$50.23 per share for an aggregate cost of \$48.0 million (excluding broker commissions) during the period January 1, 2013 through June 30, 2013.

Following is a summary of stock repurchases made during the three months ended June 30, 2013:

| Period | Total number of Shares Purchased | Average Price Paid per Share(2) | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plan (in thousands)(1)(2) |
|--------------------|----------------------------------|---------------------------------|--|--|
| April 1 - 30, 2013 | 269,015 | \$ 49.81 | 269,015 | \$ 103,704 |
| May 1 - 31, 2013 | 146,971 | \$ 51.22 | 146,971 | 96,176 |
| June 1 - 30, 2013 | | | | 96,176 |
| | 415,986 | | 415,986 | \$ 96,176 |

- (1) Excludes amounts that could be used to repurchase shares acquired under the Company's equity incentive plans to satisfy withholding tax obligations of employees and non-employee directors upon the vesting of restricted stock units.
- (2) Excludes broker commissions.

The Company made no open market purchases for the period from July 1, 2013 through July 22, 2013.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

None.

Item 5. Other Information.

On July 24, 2013 the Company's board of directors approved an increase and extension of the current \$200 million stock repurchase plan which authorizes the Company to purchase up to \$300 million of its outstanding common stock through October 25, 2015. As of July 24, 2013, the total dollar value remaining under the increased authorization was \$196.2 million. The shares may be purchased from time to time in open market transactions (including blocks) or in privately negotiated transactions. The timing of repurchases and the actual amount purchased will depend on a variety of factors including the market price of the Company's shares, general market and economic conditions, and other corporate considerations. Repurchases may be made pursuant to plans intended to comply with Rule 10b5-1 under the Securities Exchange Act of 1934, which could allow the Company to purchase its shares during periods when it otherwise might be prevented from doing so under insider trading laws or because of self-imposed trading blackout periods. Repurchases are expected to be funded from working capital and anticipated cash from operations. The repurchase authorization does

Table of Contents

not require the purchase of a specific number of shares and is subject to suspension or termination by the Company's board of directors at any time.

Item 6. Exhibits.

| Exhibit No. | Description |
|--------------------|---|
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished). |
| 32.2 | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished). |
| 101 | The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2013 formatted in Extensible Business Reporting Language (XBRL): (i) the Consolidated Statements of Comprehensive Income, (ii) the Consolidated Balance Sheets, (iii) the Consolidated Statements of Cash Flows and (iv) related notes. |

