2000 Annual Report

Magellan Health Services

Financial highlights

Fiscal years ended September 30,
(in millions, except per share amounts)

	2000	1999
Revenues	$ 1,655.0	$ 1,483.0
Segment profit	$ 208.6	$ 204.3
Cash flow from operations	$ 84.5	$ 41.9
Adjusted income from continuing operations available to common shareholders*	$ 19.9	$ 27.4
Adjusted income from continuing operations available to common shareholders per share*	$ 0.62	$ 0.86
Covered lives	$ 69.4	$ 64.5
Bank term debt outstanding**	$ 437	$ 492

** Adjusted income excludes integration costs and special charges.*
***Includes $26 million of debt paydown from issuance of preferred stock.*

Letter to our shareholders

Fiscal 2000 has been a challenging year for Magellan Health Services' shareholders. While our core behavioral health business has performed well, the specialty division, which we previously had more optimistic expectations for, has performed poorly, ultimately leading to our decision to exit this segment. Our decision to move into the specialty medical division provided many opportunities to generate business. However, these opportunities were hampered by inappropriate pricing, less than satisfactory contractual relationships, health plans' general unwillingness to delegate authority to actually manage the provider relationships or conduct utilization review and the difficulties of health plans to accurately track specific specialty data.

I want to reassure investors that the decision to exit our specialty division will have no further impact on the future operating results of Magellan. Further, I will lay out the numerous steps that we are taking to improve Magellan's overall results and stock price.

Considering Magellan's current financial structure, the need to allocate capital to vehicles providing the best short to mid-term return, and the desire to leverage industry trends supporting rapid growth in the behavioral arena, I believe the decision to focus on our core behavioral business is the proper path for Magellan. This will allow the Company to continue to enhance efficiency while deleveraging the balance sheet and improving liquidity.

Magellan's behavioral operations have generated the vast majority of the Company's cash flows over the past three years and the Company has recently reduced exposure to non-core assets. Moving forward, achieving our growth objectives in behavioral earnings will allow the Company to grow our earnings per share, service our interest, principal and earnout obligations over their respective terms, while still providing the necessary capital to expand our business.

To assist me in making numerous important changes for our future, I have recruited Daniel Messina as executive vice president and chief operating officer. Dan, the former CFO of Aetna/U.S. Healthcare, has had tremendous financial and business operating experience in the health care field and has been a Magellan board member for over two years. Dan brings a strong financial and operational focus to the Company and will play a key role in the future of Magellan Health Services.

Action Plans

In addition to the decision to exit our specialty businesses, we have already begun to take numerous actions to improve our overall profitability and financial stability. These steps include:

- Magellan completed bank amendments that significantly improve financial flexibility for fiscal 2000 and forward.

- Magellan decided to exit the psychiatric physician practice management business, and anticipates completing this exit by March 2001.
- Magellan has sold its interests in Canada with proceeds used to reduce debt and also to allow management to focus on domestic operations.
- Magellan is in advanced stages of negotiations for the sale of National Mentor, Inc. with half of net cash proceeds to be used to reduce term debt and half to be used to reduce our revolver and improve working capital.
- Magellan has recently reduced the run-rate of expenses by $15 million per annum in behavioral operations that will benefit fiscal 2001 and beyond.
- A significant reengineering process has been undertaken to achieve further efficiencies through consolidation of computer system platforms, process simplification and utilization of the internet to better serve customer and provider needs and to reduce administrative burdens.
- Magellan is taking numerous steps to improve employee morale that will benefit overall customer service and retention, efficiency and revenue growth.

I believe these are key steps in improving Magellan's earnings potential and valuation in the marketplace. Also important are key macro trends that support my belief in the strong growth potential of the broader behavioral health market. Non-discrimination (parity) legislation continues to drive demand and will likely accelerate with the passage of federal legislation. Recent medical cost inflation has also prompted HMOs and health plans to retain less risk for mental health and other benefits where they may not have adequate expertise to manage the care in-house. This in turn is leading to more new business opportunities for Magellan.

Magellan will continue to focus on improving its balance sheet and strengthening its expense administration. I am convinced that Magellan's focus on, and improvement in, its core behavioral operations coupled with compelling market dynamics, elimination of distractions, and administrative expense management will result in a more streamlined company, improving profitability and a stock price that will reflect the benefits of these actions.

Henry Harbin

Henry T. Harbin, M.D.
President and Chief Executive Officer

Questions and Answers
with Magellan Health Services COO, Daniel S. Messina




A unique inside perspective

Q **As a board member and now an executive management member, what are your initial impressions of Magellan Health Services?**

A I believe Magellan Health Services has tremendous potential because of strong market position and extensive management experience associated with behavioral managed care operations. Clearly, Magellan has been distracted by non-core activities like hospital and franchising interests, international operations, non-behavioral specialty managed care and, to a lesser extent, National Mentor, Inc. Management's renewed focus on our core business will, I believe, show improvements in customer service, profitability, and enhanced financial stability.

Favorable trends of an expanding marketplace

Q **What key healthcare trends support further industry growth?**

A Mental health treatment continues to gain wide acceptance while treatment methodology advances rapidly. Federal and state legislatures have focused more on the difference in coverage provided for "traditional" medical coverage vs. mental health coverage. In fact, 32 states have enacted parity legislation that requires mental health coverage that's equivalent to the medical coverage provided. Additionally, President Clinton signed an Executive Order requiring mental health parity coverage for all federal employees effective January 1, 2001. Recently proposed federal legislation would provide parity coverage for all health beneficiaries nationwide. These laws encourage health plans and corporations to seek effective management of these costs and a vendor that will ensure that covered employees have access to the most up-to-date treatments that result in the highest quality behavioral care outcomes.

The Behavioral Industry publication *Open Minds* estimates that there are 209 million people in behavioral managed care programs with only about 30% in a full risk product. The overall market has been growing at nearly 15% while the risk portion of the market is growing closer to 25%. Magellan covers 70 million individuals, ranging from children to seniors, with only about one-half of the covered lives in some type of risk product.

Magellan has aggressively reduced exposure to non-core operations and those that do not provide an acceptable return on cash. Contract terminations in the specialty managed healthcare segment, sale of the Canadian interests and other assets are all demonstration of our sharp focus on liquidity, debt reduction and our core business. This strategy should also improve our overall valuation in the marketplace.

Sharpening the focus on core operations

Q **What steps have been taken to address the recent challenges faced by the Company?**

A Magellan has aggressively simplified its operating strategy and sharpened its focus. The Company is in the process of exiting from the specialty medical managed care business and from its psychiatric physician practice management business and has sold its international interests, several other smaller assets and is in advanced negotiations surrounding a sale of National Mentor, Inc. This simplification reduces management oversight and frees remaining management to focus on the core competency of behavioral managed care. Additional benefits include improved liquidity, reduction in debt and an easier investment story that should attract new investors to Magellan and that could benefit the stock price.

The path towards improved valuation

Q **What specific actions are being considered to improve the valuation of company equity?**

A Improving the ratio of debt to equity and reducing interest expense should enhance our valuation. This can be accomplished with a combination of strategies. First, we can sell assets that are not aligned with our core strategy or are not producing sufficient cash flow return on the capital invested. These proceeds will be used to reduce debt and support our strategic business. Secondly, we can improve the return on capital investment in our core behavioral operations by reducing the costs needed to support behavioral revenues and earnings. We are aggressively following this strategy through reengineering efforts and consolidation of functions. We expect to see savings from these efforts beginning in late 2001 with more significant benefits in 2002 and 2003. As we simplify the company, improve its cost structure and strengthen management, we believe we will experience improved success in the capital markets.

A firmer commitment to the core business of managing behavioral care.




Doing what we do best–better

Q **What is being done to enhance efficiency in behavioral operations?**

A While it's clear Magellan is a marketplace leader, there is still room for improvement. Healthcare generally has been slow to adopt administrative automation. In Magellan's case, this was exacerbated by rapid acquisition activity and multiple computer platforms. However with appropriate planning and hard work, we believe we can accelerate systems consolidation and improve customer service. This should lead to substantial operating efficiencies that in turn will lead to enhanced customer service and improved provider relations.

Maximizing our talent resources

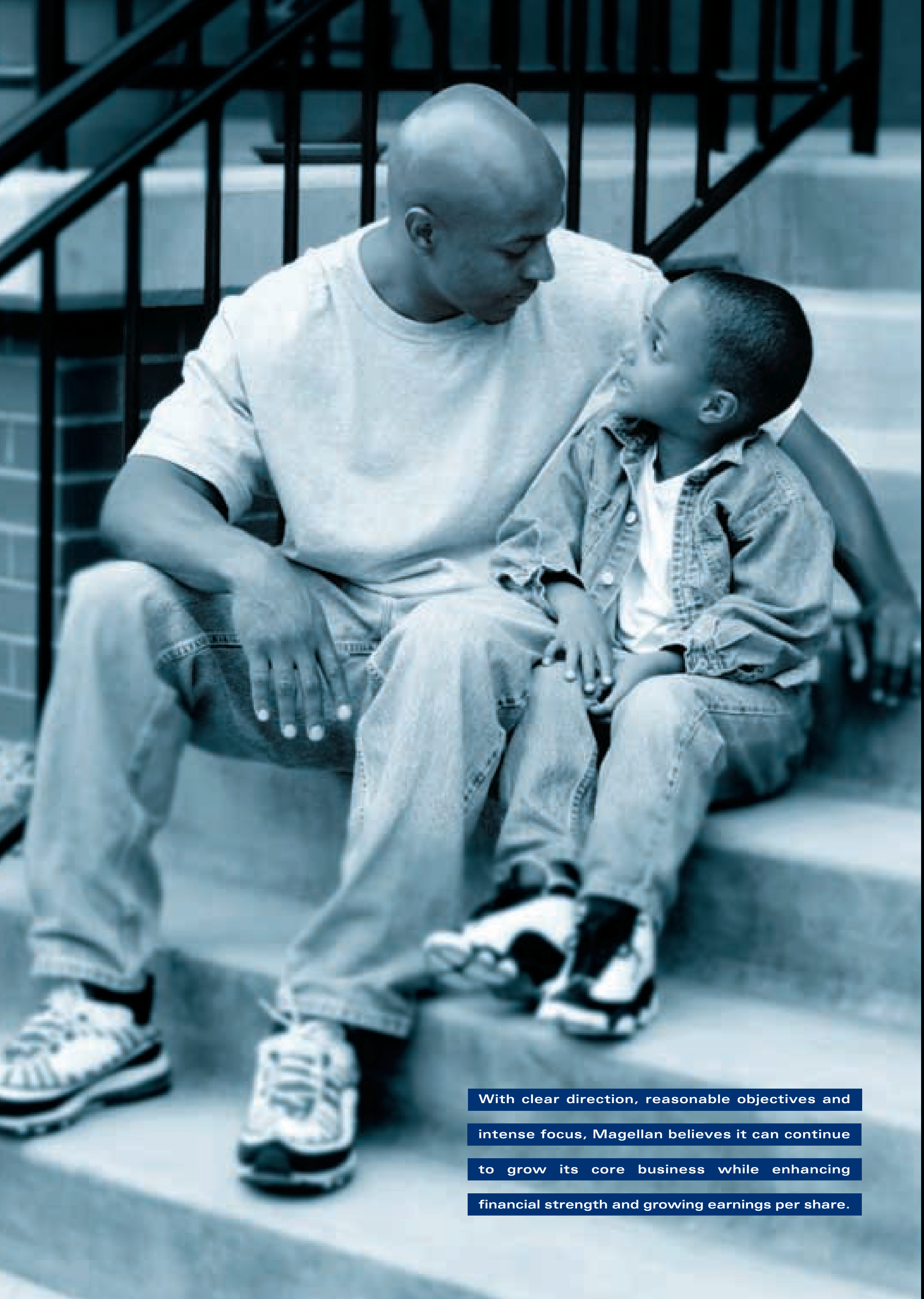
Q **Do you believe you have the management talent to achieve your objectives?**

A Absolutely. Over the last twelve months, Magellan has made a number of management changes in its efforts to refocus on its core business. These changes have included management additions from the outside as well as promotions of strong internal leaders to areas of new or additional responsibility. Clarissa Marques, who is now heading up the reengineering effort, has substantial behavioral managed care experience at several legacy companies and in varying levels of management. She has extensive clinical and managerial expertise and also understands how to efficiently achieve clinical objectives with the new technology now available. Clarissa is also adept at using a combination of internal and external resources to cost-effectively achieve the Company's objectives. Dennis Moody, who now runs the behavioral operations, also has over a decade of experience in behavioral managed care, focusing on full-risk health plan business. He has been key in maintaining, improving and expanding our services in this arena while also enhancing business efficiency. Mark Demilio, who heads up our legal and financial areas, brings many years of transactional and financial management experience to Magellan. He has served both as CFO and General Counsel in a health care environment and offers a unique set of skills that have already had a dramatic impact in the re-focus of the Company on its core operations.

Of course, each of these executives is strongly supported by the extensive expertise of managers and employees throughout the Company who are focused on achieving the same objectives.

We possess the ingredients for success and are determined to use our resources more effectively.

The key to success in this organization are the front line employees – over 6,000 of them who manage care and provide assistance for those in need. The degree with which we can improve their job satisfaction will directly impact customer service and in turn the overall success in our mission. This will be augmented with strong leadership laying out clear objectives and providing the tools necessary to achieve those objectives.



With clear direction, reasonable objectives and intense focus, Magellan believes it can continue to grow its core business while enhancing financial strength and growing earnings per share.

Direction with leadership

Q **What are your specific objectives over the next 12 to 24 months?**

A The Company expects to reduce debt with cash flow from operations, asset sales, improved cash management and diligent return on investment analysis. Utilizing a combination of reengineering, consolidation and improved use of technology directed by a strong leadership team, Magellan can improve customer service and reach a more efficient operating platform. Over time, we believe this will result in strong growth in earnings per share.

The company will not shy from dramatic measures to **generate results** for customers, employees and shareholders.

from left to right

Clarissa C. Marques, Ph.D.
Executive Vice President, Chief Administrative Officer

Mark S. Demilio
Executive Vice President
Finance and Legal, Corporate Secretary

Daniel S. Messina
Executive Vice President
Chief Operating Officer

Dennis P. Moody
Executive Vice President
Business Operations

Consolidated statements of operations

Fiscal years ended September 30,
(in thousands, except per share amounts)

	2000	1999
Net revenue	$1,873,554	$1,674,479
Costs and expenses:		
Salaries, cost of care and other operating expenses	1,652,582	1,468,879
Equity in earnings of unconsolidated subsidiaries	(9,792)	(20,442)
Depreciation and amortization	75,413	68,921
Interest, net	97,286	93,752
Stock option expense (credit)	—	18
Managed care integration costs	—	6,238
Special charges	25,398	4,441
	1,840,887	1,621,807
Income from continuing operations before income taxes, minority interest and extraordinary items	32,667	52,672
Provision for income taxes	15,478	28,256
Income from continuing operations before minority interest and extraordinary items	17,189	24,416
Minority interest	114	630
Income from continuing operations	17,075	23,786
Discontinued operations:		
Income (loss) from discontinued operations, net	(65,221)	28,325
Loss on disposal of discontinued operations, net	(17,662)	(47,423)
	(82,883)	(19,098)
Net income (loss)	(65,808)	4,688
Preferred dividend requirement and amortization of redeemable preferred stock issuance costs	3,802	—
Income (loss) available to common stockholders	(69,610)	4,688
Other comprehensive income (loss)	(102)	1,106
Comprehensive Income (loss)	$ (69,712)	$ 5,794
Weighted average number of common shares outstanding - diluted	32,386	31,916
Income (loss) per common share available to common stockholders - diluted:		
Income (loss) from continuing operations before extraordinary items	$ 0.41	$ 0.75
Income (loss) from discontinued operations	$ (2.56)	$ (0.60)
Net income (loss)	$ (2.15)	$ 0.15
Adjusted income from continuing operations available to common shareholders*	$ 0.62	$ 0.86

* *Adjusted income excludes integration costs and special charges*

These condensed financial statements should be read in conjunction with the complete financial statements and with Management's Discussion and Analysis of Financial Condition and Results of Operations which appear in the Company's Annual Report on form 10-K, which was filed with the Securities and Exchange Commission on December 26, 2000.

Consolidated statements of cash flows

Fiscal years ended September 30,
(in thousands)

	2000	1999
Cash flows from operating activities		
Net income (loss)	$ (65,808)	$ 4,688
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Gain on sale of assets	(2,442)	(23,623)
Loss on CBHS transactions	—	79,039
Depreciation and amortization	79,244	73,531
Impairment of long-lived assets	91,015	—
Other non-cash portion of special charges and discounted operations	—	(422)
Equity in earnings of unconsolidated subsidiaries	(9,792)	(20,442)
Non-cash interest expense	4,376	3,843
Cash flows from changes in assets and liabilities, net of effects from sales and acquisitions of businesses:		
Accounts receivable, net	63,057	(21,321)
Restricted cash and investments	(899)	(22,130)
Other assets	(8,246)	8,759
Accounts payable and accrued liabilities	(42,960)	(20,842)
Medical claims payable	19,767	(22,202)
Income taxes payable and deferred income taxes	(31,089)	14,143
Reserve for unpaid claims	(78)	(30,196)
Other	(9,473)	(19,015)
Total adjustments	152,480	37,188
Net cash provided by operating activities	86,672	41,876
Net cash used in investing activities	(88,111)	(19,932)
Net cash provided by (used in) financing activities	5,627	(76,554)
Net increase (decrease) in cash and cash equivalents	4,188	(54,610)
Cash and cash equivalents at beginning of period	37,440	92,050
Cash and cash equivalents at end of period	$ 41,628	$ 37,440

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Consolidated balance sheets

Fiscal years ended September 30,
(in thousands)

	2000	1999
Assets		
Current Assets:		
Cash and cash equivalents	$ 41,628	$ 37,440
Accounts receivable, net	137,224	198,646
Restricted cash and investments	117,723	116,824
Refundable income taxes	4,416	3,452
Other current assets	18,662	18,565
Total current assets	319,653	374,927
Property and equipment, net	112,612	120,667
Deferred income taxes	121,782	91,657
Investments in unconsolidated subsidiaries	12,746	18,396
Other long-term assets	10,235	9,599
Goodwill, net	1,074,753	1,108,086
Other intangible assets, net	152,006	158,283
Total assets	$ 1,803,787	$1,881,615
Liabilities and Stockholders' Equity		
Current Liabilities:		
Accounts payable	$ 40,687	$ 44,425
Accrued liabilities	175,698	209,796
Medical claims payable	219,375	189,928
Current maturities of long-term debt and capital lease obligations	34,119	30,119
Total current liabilities	469,879	474,268
Long-term debt and capital lease obligations	1,063,928	1,114,189
Deferred credits and other long-term liabilities	83,682	96,462
Redeemable preferred stock	57,834	—
Stockholders' equity:		
Common stock, par value	8,733	8,566
Additional paid-in capital	349,541	352,030
Accumulated deficit	(210,358)	(144,550)
Warrants outstanding	25,050	25,050
Common stock in treasury	(44,309)	(44,309)
Cumulative foreign currency adjustments	(193)	(91)
Total stockholders' equity	128,464	196,696
Total liabilities and stockholders' equity	$ 1,803,787	$ 1,881,615

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Directors

Robert W. Miller, Esq.
Chairman

Henry T. Harbin, M.D.
President and Chief Executive Officer
Magellan Health Services, Inc.

G. Fred DiBona, Jr., Esq.
President and Chief Executive Officer
Independence Blue Cross

David Bonderman
Managing Director, Founding Partner
Texas Pacific Group

Jonathan J. Coslet
Senior Partner
Texas Pacific Group

Andre C. Dimitriadis
Chairman and Chief Executive Officer
LTC Properties, Inc.

A.D. Frazier, Jr.
President and Chief Executive Officer
Invesco, Inc.

Gerald L. McManis
Retired President and Chief Executive Officer
McManis Associates

Daniel S. Messina
Executive Vice President,
Chief Operating Officer
Magellan Health Services, Inc.

Darla D. Moore
President, Rainwater, Inc.

Jeffrey A. Sonnenfeld
Chairman and President,
The Chief Executive Leadership Institute, Inc.

James B. Williams
Partner, CAF, Inc., The Management Affiliate of
Texas Pacific Group

Officers

Henry T. Harbin, M.D.
President and Chief Executive Officer

Daniel S. Messina
Executive Vice President,
Chief Operating Officer

Mark S. Demilio
Executive Vice President,
Finance and Legal, Corporate Secretary

Clarissa C. Marques, Ph.D.
Executive Vice President,
Chief Administrative Officer
Magellan Behavioral Health

Dennis P. Moody
Executive Vice President,
Business Operations
Magellan Behavioral Health

James R. Bedenbaugh
Senior Vice President,
Finance, Treasurer, Assistant Secretary

Thomas C. Hofmeister
Senior Vice President, Finance,
Chief Accounting Officer

Linton C. Newlin
Senior Vice President,
Finance and Corporate Taxation

J. Kevin Helmintoller, CPA
Vice President, Investor Relations

Charlotte A. Sanford
Vice President, Assistant Treasurer

shareholder information

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Columbia, MD 21046

Stock Exchange Data
Magellan Health Services, Inc.
Stock trades on the New York Stock Exchange under the ticker symbol: MGL

Transfer Agent and Registrar
First Union National Bank
Corporate Trust Operations
1525 West WT Harris Boulevard
Building 3C3
Charlotte, NC 28288-1153
Telephone: 800-829-8432

Annual Shareholders' Meeting
The annual meeting of shareholders of Magellan Health Services Incorporated will be held at The Harbor Court Hotel, 550 Light Street, Baltimore, MD 21203, at 10:00 a.m. EST on February 21, 2001

Trustee For
9% Series A Senior Subordinated Notes
Due 2008
HSBC Bank USA
140 Broadway, 12th Floor
New York, NY 10005-1180
Telephone: 212-658-6433

Independent Auditors
Arthur Andersen LLP
The Power Plant
601 East Pratt Street
Baltimore, MD 21202-3111

Investor Information
Requests for Magellan's financial documents and additional queries may be directed to:
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Magellan Health Services, Inc.
6950 Columbia Gateway Drive
Columbia, MD 21046
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Investor information including audio archives of recent conference calls and upcoming investor presentation dates, can be found on the investor relations page at **www.magellanhealth.com**

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