



Annual Report 2005



Opportunities multiply as they are seized.

– SUN TZU



Magellan Health Services is a leading managed health care services organization serving health plans, corporations and government agencies nationwide. Currently the nation’s leading manager of behavioral health and radiology benefits, we continue to grow and expand by leveraging our health expertise to deliver innovative cost management solutions to customers while collaborating with providers to positively influence members’ total health and well-being.

(In thousands, except per share data and number of employees)

OPERATIONS

Net revenue	\$ 1,808,003
Segment profit ²	\$ 245,968
Net income	\$ 130,589
Earnings per common share (diluted)	\$ 3.46
Depreciation and amortization expense	\$ 49,088
Operating cash flow	\$ 187,982
Capital expenditures	\$ 22,207
Number of employees	3,900

FINANCIAL POSITION AT YEAR END

Total assets	\$ 1,069,486
Total debt	\$ 63,084
Shareholders’ equity	\$ 633,077

1) The foregoing financial information should be read in conjunction with the financial statements and related notes as presented in Magellan’s Annual Report on Form 10-K for the year ended December 31, 2005, attached herein.

2) In the above financial table and elsewhere in this annual report, Magellan refers to segment profit. Segment profit is a non-GAAP measure consisting of net revenue less cost of care, and direct service costs and other operating expenses plus equity in earnings of unconsolidated subsidiaries. For a reconciliation of segment profit to consolidated income from continuing operations before income taxes and minority interest and a discussion of the Company’s use of segment profit in presenting its financial information, please refer to its Annual Report on Form 10-K for the year ended December 31, 2005, attached herein.

A Letter from the Chairman

Health care represents a vast, constantly changing market and this state of continuous evolution presents tremendous opportunities for Magellan. Our customers are always seeking new and effective ways of managing ever-advancing health care technology and costs while improving quality. Opportunities are continually emerging for companies with solutions to market challenges – companies like Magellan. Our 2005 achievements demonstrate that we have the vision, discipline and resources to capitalize on new opportunities in the market.

Our vision is to become a diversified managed health care services company that manages a greater portion of the health care dollar. To reach this goal we must succeed in three key areas: delivering high-quality, cost-effective care management and customer service, building a strong capital structure, and acquiring and developing new products that provide solutions to our customers' evolving needs.

In 2005 we executed our operating initiatives with disciplined precision - delivering outstanding care management and customer service and impressive financial performance for a third consecutive year. Strategically, we took an important step in our plan to become a diversified managed health care services company. In December 2005 we announced the acquisition of National Imaging Associates (NIA). NIA is the largest radiology benefits management firm in the country, managing imaging services for 17 million lives on behalf of health plans. This acquisition provides strong growth opportunities and is a major step in our expansion into new areas of health care.

I am confident that we have built a solid foundation for growth which provides us with the strength and flexibility to capitalize on strategic opportunities in the future. 2005 was a great year but it was only the first step in a much bigger plan.

DELIVERING HIGH-QUALITY, COST-EFFECTIVE SERVICE

Providing high-quality care management and customer service for our members, customers and providers is the cornerstone of our current and future success and, therefore, it is always our top priority.

We maintained excellent service again this year. In fact, it was the best in our history, with all of our major performance benchmarks in the call centers and claims payment centers exceeding our target performance measures. We continue to be an industry leader in the delivery of quality behavioral care management with more accreditations from the National Committee for Quality Assurance (NCQA) and the Utilization Review Accreditation Commission (URAC) than any other managed behavioral health care organization.

As a managed care company, we are responsible for supporting patients' health care needs and we are committed to ensuring high-quality service in the pursuit of positive health outcomes. We believe that our clinical programs support excellent quality of care and we continually seek to develop, enhance and expand our use of clinical best practices. In 2005, we enhanced and expanded our Intensive Case Management (ICM) program, which is designed to support acutely ill patients. The primary goal of the ICM program is to improve patient health and reduce hospital readmissions. Our ICM Outcomes Study shows that members enrolled in the program have significant improvement in functional health within the first 60 days of treatment.



STEVEN J. SHULMAN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER

A Letter from the Chairman

Of the enrollees who completed the program in 2005, 89 percent reported significant improvement in their mental health functioning and 83 percent reported a decrease in the number of days missed from school or work. The ICM program results in high-quality care, improved patient health, increased productivity and lower costs through a reduction in hospital readmissions. Improving health while reducing costs – that is how we deliver value to our members and our customers every day.

Achieving quality service in a cost-effective manner – driving for the most efficient and effective operational platform – has been a critical element of our long-term plan. Over the past three years we have invested in improving our call center technology and our information technology (IT) systems in order to reduce costs while maintaining or improving the quality of our service. In 2005 we continued to refine our front-line operations and corporate functions while diligently focusing on maintaining excellent service for our customers. The result of these efforts has been a reduction in our administrative costs as a percent of revenue by 390 basis points over the past two years – from 23.9 percent in 2003 to 20.0 percent in 2005.

BUILDING A STRONG CAPITAL POSITION

Our continued financial discipline and focus on operational efficiency drove another excellent financial year and we ended 2005 with segment profit of \$246 million*. This strong performance yielded excellent cash generation, which gave us the financial strength and flexibility to improve the company's capital structure and make strategic acquisitions – we did both.

In November 2005 we redeemed our \$240.6 million of 9¾% Senior Notes. This debt had a high interest rate and, given that this debt load was unnecessary due to our cash position, we repaid these notes at our earliest opportunity. This reduction in debt will be accretive to earnings on an annualized basis by approximately 22 cents per share. In addition, we paid off our \$49 million note to Aetna in conjunction with the sale of certain assets to Aetna. As a result of these efforts, we ended 2005 with \$274 million in unrestricted cash and investments and only \$63 million of debt and, therefore, are in a great capital position to support our strategic initiatives.

ACQUIRING AND DEVELOPING NEW PRODUCTS

We have consistently stated that our long-term strategic goal is to manage a greater percentage of the health care dollar.

* See footnote 2, page 1

A Letter from the Chairman

Our historical core business, managed behavioral health care, represents roughly two percent to three percent of the commercially managed health care dollar. By expanding the areas of health care for which we manage costs, we will be expanding our markets and dramatically increasing our growth opportunities.

Magellan has significant strategic assets that can be leveraged as we expand into new areas of managed health care:

- *Premier client base* – Magellan's behavioral customers include nearly half of all Blue Cross Blue Shield plans, many government entities, and approximately 1,400 employers. We have excellent long-term relationships with these clients and we believe that there is significant opportunity to cross-sell new products to them.
- *Leverageable operational platform* – Magellan has a scalable operational infrastructure – including call centers, claims payment capabilities, and experience in network development and management – that can be leveraged as we expand our products. In addition, our sophisticated IT infrastructure has been customized to support specialized managed care services and interface with health plan IT systems. We have

made significant investments in our IT systems and call centers over the last three years to elevate them to their current efficient state and we believe that these platforms can be leveraged as we expand into managing new areas of health care.

- *Strong balance sheet* – Our strong cash flow and capacity to take on additional debt offer the opportunity to accelerate growth by expanding our business through acquisition and new product development. Furthermore, our balance sheet provides us with the financial strength needed to offer risk-based contracts as we expand into other areas of health care.
- *Seasoned management team* – Our management team has exceptional depth and breadth of experience in health care. We have a premier team of behavioral managed care executives, as is evidenced by our industry leadership and consistently strong operational and financial performance. In light of our strategic direction, we have spent the last three years recruiting high-caliber executives from other areas of health care including medical managed care, pharmacy benefits management and disease management. As a result, we have built a diverse team with the critical expertise and leadership needed to move the company into new areas of health care.

NIA: EXECUTION OF STRATEGY

The NIA acquisition is an excellent example of the execution of our strategy. Radiology benefits management fits our defined criteria for new markets of interest in health care:

- Radiology costs represent a material expense for health care purchasers. Commercial insurers typically spend between \$12 and \$20 per member per month on radiology services. NIA focuses primarily on the management of advanced diagnostic imaging services such as MRIs, CT and PET scans and nuclear cardiology, which represent approximately 15 percent of the volume in imaging services but account for roughly 50 percent of radiology costs.

- Unmanaged radiology costs have been increasing at rates in excess of 20 percent a year. The advanced imaging procedures that NIA manages are estimated to be driving nearly 75 percent of this trend.

- NIA's experience has shown that about one-third of advanced tests are either clinically inappropriate or do not contribute to the physician's diagnosis or treatment. Through the management of these services, NIA has been able to demonstrate significant savings for its customers and has been successful in cutting imaging cost trends of greater than 20 percent by more than half.

Our vision includes leveraging our current customer base into new products and we see a tremendous opportunity to expand NIA's business by cross-selling radiology management into our behavioral customer base. NIA currently serves health plan clients, including several large Blue Cross Blue Shield plans. However, there is very little overlap between NIA and Magellan's health plan customer base, which provides an opportunity for cross-selling. In addition, NIA's business does not include any direct Medicaid contracting with states or direct contracting with large self-insured employers. We see great opportunities to open doors in these new markets and further accelerate NIA's growth.

We also believe that we have the ability to leverage Magellan's operational and financial strengths to facilitate NIA's growth into risk-based products. NIA currently does not take insurance risk for its services and instead manages costs for its customers on an Administrative Services Only (ASO) basis. Selling just one risk contract could more than double the size of NIA's current revenues. A mid-sized health plan client on a risk basis could generate over \$200 million in annual revenues.

NIA did not have the operational platform or the financial strength to move quickly into risk-based products; however, Magellan has

the skills and resources necessary to support NIA's expansion into risk business.

- Operational platform – NIA historically delivered exceptional value to its customers primarily through utilization review. It did not have a provider network and did not pay claims. Magellan has the operational infrastructure, including claims payment technology and expertise combined with skills and resources in network development and management, that will facilitate NIA's expansion into risk-based products. Magellan also has a sophisticated IT infrastructure that has been customized to support a specialized managed care business and interface

with health plan IT systems. We believe that we have an excellent operational platform to support full-service, risk-based products, which will dramatically increase the value NIA creates for its customers.

- Financial strength and underwriting expertise – Magellan has a strong balance sheet and a proven track record in assuming risk on behalf of its clients. We believe NIA will be able to move into the risk business more quickly with Magellan's financial strength, strong reputation and expertise in underwriting risk business behind it.

A Letter from the Chairman



(left to right)

RENÉ LERER, M.D., PRESIDENT AND CHIEF OPERATING OFFICER

STEVEN J. SHULMAN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER

CASKIE LEWIS-CLAPPER, CHIEF HUMAN RESOURCES OFFICER

DANIEL N. GREGOIRE, CHIEF LEGAL OFFICER AND SECRETARY

MARK S. DEMILIO, CHIEF FINANCIAL OFFICER

ERIC S. REIMER, CHIEF GROWTH OFFICER

ACQUISITION AND DEVELOPMENT

When identifying new markets in health care, we look for areas that meet the following criteria:

- Markets that represent a meaningful portion of the health care dollar;
- Costs that are growing at a faster rate than other health care expenses;
- Areas where costs are separable from other medical costs and are measurable;
- Areas where we can demonstrate value through improved outcomes and reduced costs.

We have taken a two-pronged approach to executing our expansion into new areas of health care that fit our criteria: acquisition and development.

Acquisition

We are disciplined in our acquisition activities, as demonstrated by our having spent more than a year of research and diligence on various companies before announcing the acquisition of NIA.

We believe NIA will be a strong growth engine for us. The commercial market for radiology benefits management is approximately three to four times larger than the commercial market for behavioral health managed care. Radiology benefits management is still a relatively young industry and NIA has been experiencing both membership and revenue growth in excess of 20 percent per year. There is very little overlap in our combined behavioral and radiology customer base, which creates excellent cross-selling opportunities as we move forward together. In addition, most of NIA's business is sold on a non-risk basis and by leveraging Magellan's financial and operational assets, we believe that we can move into risk-based products which have the potential to expand our radiology revenues dramatically.

Sound strategic acquisitions will continue to be a key component of our growth initiatives in the future, expanding our market and accelerating our overall growth rate. We will focus on acquisition targets that would accelerate our growth in either our current products or new areas of health care. Our powerful cash flow generation allows us to aggressively pursue strategic acquisitions and is balanced by our commitment to continue to exercise financial discipline in our acquisition efforts.

Product Development

We continue our work on developing our suite of new products. Our *Condition Care Management: Behavioral Health* product, through which we provide disease management for members with chronic behavioral health conditions, is well underway. Four million lives were enrolled in our program at the end of 2005 and we project 5.6 million lives to be enrolled by the end of the first quarter of 2006. Further, pilots are underway in our *Condition Care Management: Med/Psych* and *Condition Care Management: Obesity* programs.

In addition, we announced in the fall of 2005 that we would be launching a pilot of our Magellan *EnhanceMed*SM product with TennCare, offering us a significant "proof of concept" opportunity for our new psychotropic pharmacy management product and facilitating our ability to sell it in the market. In collaboration with TennCare, this pilot targets inappropriate drug treatment of depression and Attention Deficit Hyperactivity Disorder in members under the age of 21 in TennCare. The program, which launched successfully in January 2006, initially covers approximately 200,000 individuals. We are very pleased to support the state of Tennessee and its efforts to improve the quality of care for children and young people in a unique and innovative way and I look forward to sharing more information on the pilot with you in the future.

A Letter from the Chairman

MOVING FORWARD

2005 was an excellent year financially, operationally, and strategically. Our success was driven by a sound strategy and strong leadership, but it would not have been achieved without the diligent work of our experienced and motivated team of employees. Quality service and results have been delivered by every level of the organization and I am proud to serve alongside such a dedicated and talented team. We have succeeded in delivering excellent financial results while delivering outstanding service and, at the same time, we worked to build a foundation for a successful future. Our performance in 2005 has left us well positioned for future growth and I am confident in this team’s ability to seize the opportunities in front of us.

Having built a strong foundation for growth, 2006 represents an exciting year for us as we continue to execute on our strategic initiatives. Growth of our managed behavioral health care business and new products continues to be a key priority. Growth in the Medicaid market offers excellent new business opportunities for us and in 2005 we began to invest more heavily in public sector business development resources than Magellan has ever done historically. In addition, we have invested significant time and resources in new product development and marketing. Our pipeline of sales opportunities is robust as we move into 2006 and our investments in business development leave us well positioned to win new managed behavioral health care business in the future.

2006 will be a year of development, integration and execution in radiology benefits management. We closed on the NIA acquisition in January of 2006 and this year we will be operationally focused on platform integration with NIA, modification of our IT systems for radiology claims payment capabilities, and building a national radiology provider network. From a sales perspective, we will be diligently working to capitalize on the considerable growth opportunities that we see for this new segment of our business.

While we are very excited about the prospects in both the behavioral and radiology benefits management markets in the near term, it is important to understand that these segments of our business are part of a long-term strategy to grow Magellan into a diversified managed health care services company. With significant capital available to us through existing cash, strong cash flow generation and significant untapped debt capacity, we have the resources to materially increase the size of our company. We have the operational platform, the management team and the financial resources to transform Magellan into a diversified health care company that is much larger and broader in its reach than it is today.

We have built a strong foundation for growth over the next several years, driven by both sales and new acquisitions. Our entire team is diligently focused on continuing to execute on our strategic plan and we remain committed to delivering exceptional value to both our customers and our shareholders.

Thank you for your continued support.

Steven J. Shulman
Chairman and Chief Executive Officer

Officers and Board of Directors

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Eric S. Reimer
Chief Growth Officer

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Shareholder Information

WEB SITE

www.MagellanHealth.com

TRANSFER AGENT

American Stock Transfer & Trust Company

59 Maiden Lane

New York, NY 10038

Toll Free: 866-668-6550

Our transfer agent can help with a variety of shareholder-related services including:

- Change of Address
- Lost Stock Certificates
- Transfer of Stock to Another Person
- Additional Administrative Services

INVESTOR RELATIONS

This annual report along with a variety of other financial materials can be viewed at www.MagellanHealth.com.

Inquiries may be directed to the Magellan Investor Relations Group at 877-645-6464 or by sending an e-mail to ir@magellanhealth.com.

ANNUAL MEETING

Magellan's annual shareholder meeting will be held on May 16, 2006 at the Avon Old Farms Inn, 1 Nod Road, Avon, CT. The meeting will begin at 9:00 a.m.

AUDITORS

Ernst & Young

Baltimore, MD

STOCK LISTING

Symbol: MGLN

Nasdaq Stock Exchange

SAFE HARBOR STATEMENT

Certain of the statements made in this report constitute forward-looking statements contemplated under the Private Securities Litigation Reform Act of 1995 and are qualified in their entirety by the complete discussion of risks set forth in the section entitled "Risk Factors" in Magellan's Annual Report on Form 10-K for the year ended December 31, 2005, attached herein.

