MAGELLAN HEALTH SERVICES INC
Form 10-Q
October 24, 2013

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 30, 2013

Or

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

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

MAGELLAN HEALTH SERVICES, INC.

(Exact name of registrant as specified in its charter)

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding twelve months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No o

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

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

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

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

The number of shares of the registrant's Ordinary Common Stock outstanding as of September 30, 2013 was 27,067,781.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands, except per share amounts)

	December 31, 2012	September 30, 2013 (unaudited)
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 189,464	$ 281,792
Restricted cash	226,554	208,567
Accounts receivable, less allowance for doubtful accounts of $4,612 and $4,621 at December 31, 2012 and September 30, 2013, respectively	138,253	157,248
Short-term investments (restricted investments of $88,332 and $139,758 at December 31, 2012 and September 30, 2013, respectively)	201,127	212,949
Deferred income taxes	31,698	29,546
Pharmaceutical inventory	45,727	47,407
Other current assets (restricted deposits of $20,846 and $26,563 at December 31, 2012 and September 30, 2013, respectively)	38,595	48,244
Total Current Assets	871,418	985,753
Property and equipment, net	136,548	163,552
Long-term investments (restricted investments of $32,563 and $14,747 at December 31, 2012 and September 30, 2013, respectively)	32,563	15,629
Other long-term assets	9,730	15,052
Goodwill	426,939	426,939
Other intangible assets, net	34,935	28,072
Total Assets	$ 1,512,133	$ 1,634,997
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 17,081	$ 15,930
Accrued liabilities	100,778	107,190
Medical claims payable	198,429	217,290
Other medical liabilities	76,914	74,197
Current maturities of long-term capital lease obligations		2,846
Total Current Liabilities	393,202	417,453
Long-term capital lease obligations		24,167
Deferred income taxes	34,086	32,766
Tax contingencies	60,697	32,846
Deferred credits and other long-term liabilities	6,815	9,036
Total Liabilities	494,800	516,268
Preferred stock, par value $.01 per share		
Authorized 10,000 shares at December 31, 2012 and September 30, 2013 Issued and outstanding none		
Ordinary common stock, par value $.01 per share		
Authorized 100,000 shares at December 31, 2012 and September 30, 2013 Issued and outstanding 45,928 and 27,353 shares at December 31, 2012, respectively, and 46,599 and 27,068 shares at September 30, 2013, respectively	459	466
Multi-Vote common stock, par value $.01 per share		
Authorized 40,000 shares Issued and outstanding none		
Other Stockholders' Equity:		

Additional paid-in capital		848,238		890,932
Retained earnings		975,232		1,082,002
Accumulated other comprehensive loss		(35)		(72)
Ordinary common stock in treasury, at cost, 18,575 and 19,531 shares at December 31, 2012 and September 30, 2013, respectively		(806,561)		(854,599)
Total Stockholders' Equity		1,017,333		1,118,729
Total Liabilities and Stockholders' Equity	$	1,512,133	$	1,634,997

See accompanying notes to consolidated financial statements.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(In thousands, except per share amounts)

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2013
Net revenue:				
Managed care and other	$ 711,092	$ 775,957	$ 2,114,149	$ 2,255,748
Dispensing	87,345	97,641	262,974	282,359
Total net revenue	798,437	873,598	2,377,123	2,538,107
Cost and expenses:				
Cost of care	516,238	570,187	1,543,361	1,642,944
Cost of goods sold	81,662	91,853	245,555	265,440
Direct service costs and other operating expenses(1)	135,574	156,834	412,496	440,958
Depreciation and amortization	15,239	17,654	45,172	50,770
Interest expense	537	789	1,713	2,191
Interest income	(350)	(291)	(1,619)	(1,002)
	748,900	837,026	2,246,678	2,401,301
Income before income taxes	49,537	36,572	130,445	136,806
(Benefit) provision for income taxes	(16,725)	(10,660)	16,420	30,036
Net income	66,262	47,232	114,025	106,770
Net income per common share basic (See Note B)	$ 2.41	$ 1.75	$ 4.17	$ 3.96
Net income per common share diluted (See Note B)	$ 2.36	$ 1.70	$ 4.10	$ 3.87
Other comprehensive income:				
Unrealized gains (losses) on available-for-sale securities(2)	120	110	208	(37)
Comprehensive income	$ 66,382	$ 47,342	$ 114,233	$ 106,733

(1) Includes stock compensation expense of $4,468 and $4,524 for the three months ended September 30, 2012 and 2013, respectively, and $13,935 and $14,764 for the nine months ended September 30, 2012 and 2013, respectively.

(2) Net of income tax provision (benefit) of $78 and $74 for the three months ended September 30, 2012 and 2013, respectively, and $134 and $(25) for the nine months ended September 30, 2012 and 2013, respectively.

See accompanying notes to consolidated financial statements.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE NINE MONTHS ENDED SEPTEMBER 30,

(Unaudited)

(In thousands)

	2012	2013
Cash flows from operating activities:		
Net income	$ 114,025	$ 106,770
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	45,172	50,770
Non-cash interest expense	544	552
Non-cash stock compensation expense	13,935	14,764
Non-cash income tax expense (benefit)	12,395	(164)
Non-cash amortization on investments	5,373	7,273
Cash flows from changes in assets and liabilities, net of effects from acquisitions of businesses:		
Restricted cash	(59,777)	17,987
Accounts receivable, net	604	(19,231)
Pharmaceutical inventory	(2,002)	(1,680)
Other assets	(4,218)	(9,781)
Accounts payable and accrued liabilities	(17,854)	6,685
Medical claims payable and other medical liabilities	37,422	16,144
Tax contingencies	(34,616)	(22,981)
Other	654	4,174
Net cash provided by operating activities	111,657	171,282
Cash flows from investing activities:		
Capital expenditures	(53,049)	(42,091)
Purchase of investments	(197,525)	(235,946)
Maturity of investments	215,150	233,723
Other		(7,900)
Net cash used in investing activities	(35,424)	(52,214)
Cash flows from financing activities:		
Payments to acquire treasury stock		(49,462)
Proceeds from exercise of stock options and warrants	13,092	24,548
Payments on capital lease obligations		(2,310)
Other	135	484
Net cash provided by (used in) financing activities	13,227	(26,740)
Net increase in cash and cash equivalents	89,460	92,328
Cash and cash equivalents at beginning of period	119,862	189,464
Cash and cash equivalents at end of period	$ 209,322	$ 281,792
Supplemental cash flow data:		
Non-cash investing activites:		
Property and equipment acquired under capital leases	$	$ 29,323

See accompanying notes to consolidated financial statements.

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 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 nine months ended September 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. Other than as described in Note E "Subsequent Events", the Company did not have any material recognizable subsequent events during this period.

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

Business Overview

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

Managed Behavioral Healthcare

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

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

NOTE A General (Continued)

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

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

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

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

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

Radiology Benefits Management

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

Pharmacy Solutions

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

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 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 managed care organizations ("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

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 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.

In July 2013, the FASB issued ASU No. 2013-11, "Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Carryforward Exists" ("ASU 2013-11"). ASU 2013-11 provides guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. An unrecognized tax benefit should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward with certain exceptions, in which case such an unrecognized tax benefit should be presented in the financial statements as a liability. The amendments in this ASU do not require new recurring disclosures. The amendments in this ASU are effective for reporting periods beginning after December 15, 2013. The guidance is not expected to materially 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 $631.6 million and $1,871.4 million for the three and nine months ended September 30, 2012, respectively, and $673.6 million and $1,957.9 million for the three and nine months ended September 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

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

NOTE A General (Continued)

are performed and as costs are incurred. Revenues from these contracts approximated $33.8 million and $104.8 million for the three and nine months ended September 30, 2012, respectively, and $52.6 million and $152.9 million for the three and nine months ended September 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 $32.6 million and $90.5 million for the three and nine months ended September 30, 2012, respectively, and $32.3 million and $96.9 million for the three and nine months ended September 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 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 $2.6 million and $14.5 million for the three and nine months ended September 30, 2012, respectively, and $2.7 million and $6.1 million for the three and nine months ended September 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 $10.3 million and $29.3 million for the three and nine months ended September 30, 2012, respectively, and $8.8 million and $25.6 million for the three and nine months ended September 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 $87.3 million and $263.0 million for the three and nine months ended September 30, 2012, respectively, and $97.6 million and $282.4 million for the three and nine months ended September 30, 2013, respectively.

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

NOTE A General (Continued)

Significant Customers

Consolidated Company

The Company provides behavioral healthcare management and other related services to approximately 685,000 members in Maricopa County, Arizona as the Regional Behavioral Health Authority ("RHBA") for GSA6 ("Maricopa County") pursuant to a contract with the State of Arizona (the "Maricopa Contract").

The Maricopa 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. 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, 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 was scheduled to expire on October 1, 2013. The Company and the State of Arizona have agreed to extend the Maricopa Contract through March 31, 2014. 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, after January 1, 2014, without cause upon 30 days prior notice to the Company. The Maricopa Contract generated net revenues of $566.2 million and $557.6 million for the nine months ended September 30, 2012 and 2013, respectively.

The State of Arizona had previously issued a Solicitation for a new RBHA for Maricopa County (the "New Contract") to replace the current contract with the Company to be effective on October 1, 2013. The New Contract is for the management of the publicly funded behavioral health system currently provided by the Company under the Maricopa Contract, and also includes an integrated behavioral and physical health care system for a small number of individuals with serious mental illness. Magellan Complete Care of Arizona, a joint venture owned 80% by the Company and 20% by Vanguard/Phoenix Health Plan, previously submitted a bid for the Contract.

On March 25, 2013, the Company was notified that Magellan Complete Care of Arizona was not selected as the RBHA for the New Contract. On April 3, 2013, the Company 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").

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

NOTE A General (Continued)

On June 13, 2013 the DOA referred the Appeal for a hearing before an independent administrative law judge in the Arizona Office of Administrative Hearings (the "OAH"). The OAH held an evidentiary hearing on the Appeal on September 18-27, 2013. Post-hearing briefing will be completed by October 29, 2013 and the Company anticipates the administrative law judge will issue her decision and recommendation to DOA on or before November 18, 2013. The DOA will then have 30 days to review the administrative law judge's decision and recommendation and issue its decision on Magellan's appeal of the protest denial. There is no assurance that the Company will prevail on the Appeal or that the Stay will remain in effect.

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 nine months ended September 30, 2012 and 2013 (in thousands):

Segment	Term Date	2012	2013
Commercial			
Customer A	Mid-2014(1)	$ 144,499	$ 156,269
Customer B	December 31, 2019	101,249	106,433
Customer C	December 31, 2012 to December 14, 2013(2)(3)	89,592	58,246
Public Sector			
Customer D	June 30, 2014(4)	175,440	209,266
Radiology Benefits Management			
Customer E	December 31, 2015	83,158	96,402
Customer F	June 30, 2014	44,959	43,490
Customer G	July 31, 2015	42,458	47,161
Customer H	January 31, 2014	27,824	34,338
Pharmacy Solutions			
Customer I	November 30, 2013 to December 31, 2013(2)	98,128	99,599
Customer J	December 31, 2013(5)	45,018	43,315*
Customer K	December 31, 2013(5)	53,640	68,166
Customer L	September 30, 2013(6)	53,259	48,527

*

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. The Company anticipates the contract will extend through mid-2014 to allow for transition to new vendor.

(2)

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

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

NOTE A General (Continued)

(3)
Revenues for the nine months ended September 30, 2012 of $38.0 million relate to a contract that terminated as of December 31, 2012. The customer has informed the Company that is has decided not to renew the remaining contract after the contract expires on December 14, 2013.

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

(5)
The Company has received notification that the customer will not renew its contracts for specialty pharmacy and related services. The Company has multiple contracts that are currently scheduled to terminate on December 31, 2013.

(6)
This customer represents a subcontract with a Public Sector customer and is eliminated in consolidation.

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 $269.8 million and $269.1 million for the nine months ended September 30, 2012 and 2013, respectively. Net revenues from the Florida Areas in the aggregate totaled $100.6 million and $97.8 million for the nine months ended September 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,

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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.

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 September 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

	September 30, 2013			
	Level 1	**Level 2**	**Level 3**	**Total**
Cash and cash equivalents(4)	$	$ 75,861	$	$ 75,861
Restricted cash(5)		117,611		117,611
Investments:				
U.S. government and agency securities	1,130			1,130
Obligations of government-sponsored enterprises(3)		8,410		8,410
Corporate debt securities		218,288		218,288
Taxable municipal bonds		600		600
Certificates of deposit		150		150
September 30, 2013	$ 1,130	$ 420,920	$	$ 422,050

(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 $205.9 million of cash held in bank accounts by the Company.

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(Unaudited)

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(5) Excludes $91.0 million of restricted cash held in bank accounts by the Company.

For the nine months ended September 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.

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 September 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 nine months ended September 30, 2012 or 2013. The following is a summary of short-term and long-term investments at December 31, 2012 and September 30, 2013 (in thousands):

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

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	September 30, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. government and agency securities	$ 1,130	$	$	$ 1,130
Obligations of government-sponsored enterprises(1)	8,408	3	(1)	8,410
Corporate debt securities	218,411	28	(151)	218,288
Taxable municipal bonds	600			600
Certificates of deposit	150			150
Total investments at September 30, 2013	$ 228,699	$ 31	$ (152)	$ 228,578

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

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

	Amortized Cost	Estimated Fair Value
2013	$ 99,253	$ 99,211
2014	121,593	121,522
2015	7,853	7,845
Total investments at September 30, 2013	$ 228,699	$ 228,578

Note Receivable and Preferred Stock

The Company holds a 7% equity interest in AlphaCare of New York, Inc. ('AlphaCare") through an equity investment of $2.0 million in preferred membership units of AlphaCare's current holding company, AlphaCare Holdings, LLC on May 17, 2013. During the current year, the Company also loaned $5.9 million to AlphaCare Holdings, LLC pursuant to a promissory note (the "Note") which was secured by a pledge of all of the outstanding stock of AlphaCare. AlphaCare is a newly licensed HMO in New York that operates a New York Managed Long-Term Care Plan ("MLTCP") in Bronx, New York, Queens, Kings and Westchester Counties, and Medicare Plans in Bronx, New York, Queens and Kings Counties.

On August 13, 2013, the Company entered into a stock purchase agreement (the "Stock Purchase Agreement") under which it agreed to acquire a 65% equity interest in AlphaCare through an investment in its holding company.

As contemplated by the Stock Purchase Agreement, AlphaCare Holdings, LLC will merge with and into AlphaCare Holdings, Inc. ("AlphaCare Holdings"), a recently-formed Delaware holding corporation, and the Company's 7% equity interest and the Note will be converted into shares of Series A Participating Preferred Stock ("Series A Preferred") of AlphaCare Holdings. The Company will also purchase additional shares of Series A Preferred stock suc