



Getting Better All the Time™

ANNUAL REPORT 2006

MAGELLAN HEALTH SERVICES

Magellan Health Services is one of the country's leading specialty health care management organizations, serving health plans, corporations and government agencies nationwide. Currently focused on the areas of behavioral health, radiology and specialty pharmacy, we continue to grow and expand by leveraging our expertise to deliver innovative cost management solutions to customers while collaborating with providers to positively influence members' total health and well-being.

2006 FINANCIAL HIGHLIGHTS¹

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

OPERATIONS

Net revenue	\$ 1,690,270
Segment profit ²	\$ 216,284
Net income	\$ 86,262
Earnings per common share (diluted)	\$ 2.23
Depreciation and amortization expense	\$ 48,862
Operating cash flow	\$ 196,964
Capital expenditures	\$ 25,477
Number of employees	3,900

FINANCIAL POSITION AT YEAR END

Total assets	\$ 1,207,520
Total debt	\$ 41,913
Shareholders' equity	\$ 763,567

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, 2006, 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 profit or loss from continuing operations before stock compensation expense, depreciation and amortization, interest expense, interest income, gain on sale of assets, income taxes and minority interest. 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, 2006, attached herein.



Steven J. Shulman
Chairman and Chief Executive Officer

A LETTER FROM THE CHAIRMAN

A TRANSFORMATIONAL YEAR

Health care is delivered on a highly specialized, idiosyncratic basis where the vast majority of the care is provided by specialists. It is a rapidly evolving field where continuous clinical and technological advancements drive the need for constant innovation and specialized management in certain niches, creating strategic opportunity for organizations such as Magellan. Our vision of becoming a specialized managed health care company that manages a greater portion of the health care dollar builds on this opportunity. We believe that our specialized clinical expertise and operational focus drive care management that produces optimal cost containment while delivering the highest quality of care, and in 2006 – a transformational year for Magellan – we demonstrated our ability to extend that expertise into two new lines of business.

We began 2006 as a behavioral managed care company and through our acquisitions of National Imaging Associates (NIA) and ICORE Healthcare we added radiology benefits management and specialty pharmacy to our specialty product array – fundamentally changing the company’s strategic footprint. With the expansion of our specialty offerings in 2006 we have gone from managing behavioral care, which represents roughly 2% of both the commercial health care dollar and trend, to managing 15% of the commercial health care dollar and 30% of overall commercial medical trend. Having successfully executed on our strategic goals for 2006, we enter 2007 as a specialty health

care management organization with product offerings that provide significant new growth opportunities for the future.

RADIOLOGY BENEFITS MANAGEMENT

In January of 2006 we completed our acquisition of NIA. One of the largest radiology benefits management firms in the country, NIA manages advanced imaging services for over 17 million lives on behalf of health plans.

Advanced imaging technology, which includes Magnetic Resonance Imaging (MRI/MRAs), Computerized Tomography (CT), Nuclear Cardiology and Positron Emission Tomography (PETs), is the leading driver of both overall spending and cost trend in radiology. These advanced procedures account for 15% of total imaging volume, half of current costs and nearly three-quarters of the annual increase in radiology spending. Driven by advances in imaging technology, significant proliferation of machines, wide variation in both appropriateness of use and facility rates, physician self-referral incentives and an aging population, unmanaged radiology spending has been growing at an annual rate in excess of 20%. 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% by more than half.

A key component of our growth strategy is to accelerate NIA’s growth by selling radiology management services on a risk basis. This represents

a new product and an alternative to NIA’s historical non-risk model. Our vision is to leverage Magellan’s financial and operational assets into risk-based products that create the opportunity to expand our radiology revenues dramatically.

In 2006 we began to execute on this vision and announced our first risk contract, which will be with CIGNA Healthcare beginning in 2007. In addition, as I write this letter, we have just signed a second risk radiology agreement, a contract with Empire Blue Cross Blue Shield, a subsidiary of WellPoint, Inc. On a combined basis these two contracts will generate over \$250 million in annualized revenue. Signing these contracts catapults us into the management of radiology benefits on a risk basis and is validation of our strategy in this market.

SPECIALTY PHARMACEUTICAL MANAGEMENT

On July 31, 2006, we completed our acquisition of ICORE Healthcare, a privately held specialty pharmaceutical management firm. ICORE works with health plans to manage specialty drugs used in the treatment of cancer, multiple sclerosis, hemophilia, infertility, rheumatoid arthritis, chronic forms of hepatitis and other diseases.

Specialty pharmaceuticals are high-cost drugs used to treat chronic diseases. Although they are used by less than 1% of the patient population, specialty pharmaceuticals currently represent approximately 20% of total drug costs and are growing in excess of 20% per year. The introduction of new drugs to

the marketplace, broader applications of specialty drugs for a wide variety of illnesses and increasing demand by an aging population are continuing to drive growth in the specialty pharmaceutical market. With estimates that over 40% of all drugs in late-phase development are classified as specialty, costs for specialty pharmaceuticals are projected to represent nearly 30% of total drug spend in 2009.

We believe that ICORE is the most payor-centric specialty pharmaceutical firm in the industry, with services that seek to deliver notably higher savings and value to its health plan customers. ICORE works with health plans to manage specialty drugs through a range of integrated services, including:

Formulary optimization/Rebates – We believe that ICORE delivers superior value to its clients through its rebate formulary management services and that this value creation differentiates it from its competitors in the industry. ICORE has developed a preferred formulary for certain specialty pharmaceutical classes that is based on sound clinical practice while also factoring in cost implications when appropriate. If a health plan chooses to work with ICORE on rebates in a certain drug class, ICORE works to move market share based on the preferred formulary. The rebates are frequently tiered so that the higher the market share that ICORE achieves, the higher the rebates its health plan customers receive.

Part of what makes ICORE uniquely effective in maximizing rebates is that, in conjunction with its approach to formulary development, it builds



(left to right)
René Lerer, M.D.
President and Chief Operating Officer
Steven J. Shulman
Chairman and Chief Executive Officer
Mark S. Demilio
Chief Financial Officer

collaborative relationships with the physicians who prescribe specialty drugs. ICORE's management team includes pharmacists and oncology experts who have the background and expertise to understand the needs of oncologists and other specialists. ICORE's team is very active in working with the provider community to move market share based on a health plan's formulary. Through its combined use of a limited preferred formulary and active involvement with the provider community, ICORE has demonstrated a high degree of effectiveness in moving market share to preferred drugs, which ultimately delivers superior rebate results for its customers.

Specialty pharmacy distribution – Specialty drugs are high cost drugs, with costs per member typically in excess of \$10,000 per year, that are generally administered through injections or intravenously and often require special handling. Most recently we have begun to see an increase in the use of oral specialty drugs and ICORE has become more involved in the management of these drugs as well. ICORE specializes in distributing specialty drugs to patients in their homes or to physicians' offices. By managing specialty distribution, ICORE is better able to monitor and influence compliance with the preferred formulary through its interactions with providers and patients during the distribution process. This additional opportunity to promote compliance with the preferred formulary further improves ICORE's ability to move market share for preferred rebates, which ultimately improves the rebates it achieves for its health plan customers.

Strategic consulting – ICORE's consulting services provide value to a variety of stakeholders in the specialty pharmaceutical industry, and include market research, data analytics, reimbursement strategies, operational improvements and new product entries. ICORE's consulting services create additional differentiating value for its health plan customers, since much of ICORE's consulting work with health plans involves strategies to control specialty drug costs that are a component of the medical portion of the health plan benefit and that are not typically addressed by a specialty pharmacy or pharmacy benefit manager.

MANAGED BEHAVIORAL HEALTH CARE

High-quality behavioral care management has been the foundation of our historical and current success and, therefore, it is always a priority.

In 2006, we saw significant growth in our behavioral Medicaid business. As states continue to grapple with their burgeoning Medicaid budgets, growth in this market continues to offer excellent long-term opportunities for us. In 2005 we began to invest more heavily in governmental business development resources. In addition, we have invested significant time and resources in new product development and marketing. In 2006, we had tremendous success in direct carve-out business in Florida, winning five of the seven regions that were out to bid. This, we believe, is clear indication that the changes we have made in our marketing and business development efforts in the Medicaid arena have been effective.

In addition, in 2006 we implemented several new Medicaid accounts that we manage as a partner with a health plan on an integrated basis. This year we implemented accounts with WellCare, WellPoint and Aetna in which we are managing behavioral care for their Medicaid lives in certain states. This structure for Medicaid accounts, which mirrors our arrangements in the commercial side of our health plan business, is a natural extension of our public sector behavioral health expertise and our strong health plan client relationships and provides additional new growth opportunities in the expanding Medicaid market.

We continue to invest in and refine our care management services in order to enhance the quality of our service to our health plan, public sector and employer customers. Key areas of focus in 2006 included the expansion and refinement of the following programs:

> *Intensive Care Management (ICM)* – Our ICM program focuses on supporting acute patients. By targeting these high-risk members, our ICM program has demonstrated success both in improving the functional health of enrolled members and in reducing costs to the health plan. Members who complete this program show a significant improvement in their mental health functioning, a reduction in the days missed from school or work, and lower hospital readmission rates. In 2006, we continued to expand enrollment in this program and, based on the positive results to date, we will further expand the program in 2007.

> *Med/Psych Integration* – We recognize that a patient's mental and physical health are connected and thus are best treated in an integrated manner. In order to facilitate the integration of medical and behavioral health care, we have developed innovative programs that are designed to reduce medical costs through proactively identifying and treating co-morbid behavioral conditions that can be associated with chronic medical conditions. These programs provide a high level of coordinated care with real-time communications and reporting that result in improved clinical outcomes. We believe that our work in med/psych integration is of the highest quality and rivals or surpasses the level of integration that most health plans achieve when they manage both medical and behavioral health benefits internally.

> *Targeted Care Management (TCM)* – Magellan rolled out its new outpatient Targeted Care Management (TCM) initiative in 2006. The TCM program is a data-driven approach to identifying and proactively intervening in cases involving members most at risk of requiring higher levels of behavioral care and those who do not seem to be progressing in the outpatient care setting. The TCM program is based upon algorithms derived from analysis of Magellan's extensive behavioral health database supplemented with outcomes data. Based on the data analysis, some clinical intervention strategies are targeted directly to the member, while others are designed to provide additional support and data to providers.

By identifying and intervening in cases where members are at a high risk of deterioration, we are able to more efficiently and effectively manage those members most likely to have poor outcomes and high cost. We initiated this program in the third quarter of 2006 and we are pleased with its initial results.

Through constant innovation in our programs and products, we are working to distinguish ourselves in the behavioral care management industry as a company that is continually bringing forward new strategies to further improve care and reduce behavioral health costs for our health plan, public sector and employer clients.

SOLID FINANCIAL PERFORMANCE SUPPORTS

FUTURE STRATEGIC OPPORTUNITIES

Our operational performance in 2006 was excellent and produced financial results that were strong. We produced segment profit of \$216 million in 2006 and this strong performance yielded another year of excellent cash generation, with our balance sheet showing \$189 million in unrestricted cash and investments and only \$42 million of debt at year end. We enter 2007 with a great capital position to support our strategic initiatives and we continue to look at acquisitions that would support our strategic vision.

By expanding the areas of health care for which we manage costs, we have expanded our markets and dramatically increased our growth opportunities.

Sound strategic acquisitions will continue to be a key component of our growth initiatives in the future. As we look at future opportunities we will consider acquisitions that would add to our competitive strengths in areas of health care where we currently operate and, in addition, we will continue to look for new areas of health care that would add new specialty products to our current offerings.

When identifying new markets in health care, we will continue to seek out areas that meet the following criteria:

- > Markets that represent a meaningful portion of the health care dollar;
- > Markets where costs 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.

While our powerful cash flow generation allows us to consider additional acquisition opportunities, our disciplined approach means that we will balance our growth with the importance of integrating and executing well in the new markets that we enter. We are committed to deploying our capital in the most effective way to maximize long-term shareholder value which, at some point, could include capital deployment alternatives other than acquisitions such as implementing a share repurchase or a dividend. Long-term shareholder value will drive our decisions in this regard.

We are very pleased with our 2006 acquisitions and we strongly believe that these were excellent uses of our capital. These business lines provide new and robust growth opportunities and are a major step in our expansion into new areas of health care. Over the long-term we believe this strategy of expanding into new markets will create significant shareholder value.

CONTINUING THE TRANSFORMATION

Having successfully entered new markets in health care during 2006, much of our focus in 2007 will be on continuing the transformation and executing on our growth initiatives in these new markets.

In radiology benefits management, we are focused on developing our risk business. We will be implementing our first two risk contracts in 2007 and we are focused on ensuring a smooth implementation. We are committed to providing excellent service to our clients and we are working diligently to ensure the success of these contracts. In addition, we continue marketing our services and we expect to grow our radiology business by adding additional risk and ASO contracts over time.

We will also be focused on growing our specialty pharmaceutical business. For 2007, we are projecting strong revenue growth for both rebate and distribution contracts, with much of this growth coming from expansions and up-sells with existing customers. By the end of 2006, we had already sold two large distribution contracts and we sold yet another in early 2007. All three of these accounts are projected to ramp up during 2007.

In addition, we have been expanding our rebate and consulting contracts and expect to continue to grow that piece of our business. We are off to a strong start for 2007 and we are optimistic about ICORE's future growth opportunities.

While we are excited about the prospects in both radiology benefits management and specialty pharmacy, we also remain committed to our behavioral roots. We have excellent long-term prospects in Medicaid and we expect to grow and diversify our behavioral contracts over time. This core business continues to drive strong earnings and cash flow and it is this strong performance that has provided the financial resources necessary to transform Magellan into a specialty health care management company that is much larger and broader in its reach than it was just a year ago.

We are successfully executing on our vision to transform into a specialty managed health care company. We have created the platform for realizing this vision and we have built a strong foundation for growth. We remain diligently focused on executing our strategic plan and, above all, we remain committed to delivering exceptional value to our customers and the people they serve and to our shareholders.



Steven J. Shulman
Chairman and Chief Executive Officer

OFFICERS AND BOARD OF DIRECTORS

OFFICERS

Steven J. Shulman
Chairman and Chief Executive Officer

René Lerer, M.D.
President and Chief Operating Officer

Mark S. Demilio
Chief Financial Officer

Daniel N. Gregoire
Chief Legal Officer and Secretary

Caskie Lewis-Clapper
Chief Human Resources Officer

Michael T. Majerik
Chief Sales and Marketing Officer

BOARD OF DIRECTORS

Steven J. Shulman
Chairman and Chief Executive Officer
Magellan Health Services, Inc.

Saul E. Burian
Managing Director
Houlihan Lokey Howard & Zukin

Michael S. Diament
*Former Portfolio Manager and
Director of Bankruptcies*
Renegade Swish, LLC

Robert M. Le Blanc
Managing Director
Onex Corporation

René Lerer, M.D.
President and Chief Operating Officer
Magellan Health Services, Inc.

William J. McBride
Retired President and Chief Operating Officer
Value Health, Inc.

Michael P. Ressler
Retired Vice President of Finance
Nortel Networks Corporation

Barry M. Smith
Founder, Chairman and Chief Executive Officer
Bon Travay, S.A.

Allen F. Wise
Chairman
Coventry Health Care

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 15, 2007 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, 2006, attached herein.



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