



Clear vision and focused  
execution have built the  
foundation for success.

ANNUAL REPORT 2004

WE MAXIMIZE THE POWER OF OUR BEHAVIORAL HEALTH EXPERTISE TO SUPPORT INDIVIDUALS AND FAMILIES AT THE MOST SENSITIVE MOMENTS OF THEIR LIVES. WE DELIVER TRUSTED AND INNOVATIVE SOLUTIONS TO OUR CUSTOMERS AND COLLABORATE WITH OUR PROVIDERS TO POSITIVELY INFLUENCE INDIVIDUALS' TOTAL HEALTH AND WELL-BEING AND INCREASE VALUE FOR ALL OF OUR STAKEHOLDERS.

# 2004 FINANCIAL HIGHLIGHTS<sup>1</sup>

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

## OPERATIONS

Net revenue	\$ 1,795,402
Segment profit <sup>2</sup>	\$ 233,214
Net income	\$ 88,372
Earnings per common share (diluted)	\$ 2.43
Depreciation and amortization expense	\$ 42,489
Operating cash flow	\$ 163,438
Capital expenditures	\$ 30,703
Number of employees	4,300

## FINANCIAL POSITION AT YEAR END

Total assets	\$ 1,188,338
Total debt	\$ 379,478
Shareholders' equity	\$ 497,053

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, 2004 attached herein.

2) In the above financial table and elsewhere in this annual report, Magellan references segment profit. Segment profit is a non-GAAP measure consisting of net revenue less salaries, cost of care, and other operating expenses plus equity in earnings of unconsolidated subsidiaries. For a reconciliation to net income and a discussion of the company's use of segment profit in presenting its financial information, please refer to its December 31, 2004 10-K attached herein.

# A LETTER FROM THE CHAIRMAN

Magellan's success in 2004 is the result of our clear vision and focused execution. We developed a strategy and supporting business plan that would allow Magellan to operate more efficiently and effectively. At the same time we worked on repositioning the company for the future. We flawlessly executed the plan and delivered exceptional results. Our success is validation that our plan is on target and that we have built a team that can deliver impressive results.

## A REMARKABLE YEAR

2004 was a remarkable year for Magellan. In January, we completed our financial restructuring and emerged from bankruptcy with a dramatically improved capital structure. Our original goal was to reduce the company's nearly \$1.2 billion of debt to a more manageable level. We not only hit that goal – we surpassed it. With the reduction of over \$700 million of debt, the raising of \$150 million of new equity and the establishment of a new bank syndicate with improved credit agreement terms, we achieved success on the day we emerged from bankruptcy. This strong capital structure maximizes our ability to respond to business challenges as well as capitalize on new opportunities in the market.

In 2004 our key objectives were to:

- Retain customers and maintain our core business;
- Execute an operational turnaround;
- Develop innovative new products that enhance our core business.

We celebrated many successes in each of these key initiatives – more than I can list here – but I will specifically highlight a few. Not only did the following accomplishments contribute to our success in 2004, they also helped lay the foundation for a successful future.

## RETENTION

A key driver of our strong financial results in 2004 was the successful retention of the vast majority of our customers through the bankruptcy. I am proud of the long-term partnerships that we have built with our customers – partnerships that are exemplified by the fact that our 10 largest health plan clients have been with us for an average of 10 years. We continually work to maintain and grow these relationships and we have demonstrated our commitment to our customers through excellent service levels and quality care management.

Although we have been very successful in customer retention overall, we were disappointed that Aetna decided not to renew its contract with Magellan beyond 2005. While we had hoped to continue our association with Aetna, Magellan is solidly positioned both financially and operationally and the Aetna development does not change that. We renewed several other large accounts during the year and are well positioned for a strong future.

## TURNAROUND

In 2004, we continued our operational turnaround through the execution of our Performance Improvement Plan (PIP) and achieved tremendous results. Key successes from our PIP initiatives include:

- Reducing our administrative cost ratio from 24 percent of revenue in 2003 to 21 percent in 2004;
- Substantially completing the transition to a more automated claims payment environment;

- Continuing the consolidation efforts that have, over the last few years, dramatically reduced the number of information systems we use and call centers we operate;
- Implementing numerous care management initiatives that reduced our overall care trend. Our initiatives focused on decreasing medical costs by better management of claims and recovery initiatives, as well as greater focus on management of both inpatient and outpatient expenses.

## SERVICE

It is also important to note that, throughout this major restructuring of our operations, we delivered stellar service to our customers, members and providers. Some examples of this achievement include:

- Improved efficiency and effectiveness of claims processing – The speed and quality of our services beat industry standards. In 2004, 99.3 percent of our claims were paid within 30 days of receipt and the financial accuracy of our claims was 99.6 percent.
- Industry leadership in NCQA and URAC accreditations – The National Committee for Quality Assurance (NCQA) and Utilization Review Accreditation Commission (URAC), which establish quality standards for the health care industry, are recognized by our customers as the leading health care accrediting organizations. Magellan continues to hold more NCQA and URAC accreditations than any other managed behavioral health care organization – one of the greatest testimonies to the overall quality of our services.



- Sarbanes-Oxley compliance – In 2004 we received an unqualified opinion from our external auditors, Ernst & Young, regarding the effectiveness of our internal control over financial reporting as required by section 404 of the Sarbanes-Oxley Act. While we were confident in our control structure, having an independent auditing firm such as Ernst & Young conduct its own impartial review and attest to the quality of our controls provides further validation of the strength of our operations and the quality of our services and processes.

This combination of excellent service levels and a more streamlined cost structure provides a strong competitive position for us to build on as we move forward.

## STRONG OPERATIONAL RESULTS DROVE STRONG FINANCIAL RESULTS

In 2004 our operational results drove equally strong financial results. We ended the year with over \$233 million in segment profit, which was well beyond our original expectations of \$160 million to \$180 million in segment profit for the year\*. This strong financial performance resulted in excellent cash flow. By the end of the year we had \$355 million in unrestricted cash and investments while total debt was down to \$379 million. Given our strong financial performance, we were able to successfully refinance our credit agreement, which yielded both improved interest rates and greater flexibility. This solid performance has further strengthened our capital position and gives us the financial flexibility to contemplate sound, strategic acquisitions in the future.

## THE MANAGEMENT TEAM

Another important accomplishment for the company was the creation of a premier management team. I came to Magellan with several new members of our team – most notably René Lerer, our president and my trusted business partner for over 12 years. Magellan's management team already included many strong executives and we have added new individuals who brought diversified health care experience. Bringing together the best of the old and the new has created a team with extraordinary depth of talent and industry experience. Together we are improving the company today and building on our vision for the future. I encourage you to take a moment to reflect on the accomplishments that I have described above – there can be no better testimony to the quality of this team than the results that they have delivered this year.

\* See footnote 2, page 1.

## PRODUCT DEVELOPMENT

While many of our efforts in 2004 dealt with improving our current operations, we also focused substantial resources on developing new products. We feel that it is critical to jumpstart a new product lifecycle through innovation. Our market and our customers are evolving; in order to maintain our industry-leading position and grow our business, our products must continue to evolve. We have made excellent progress in new product development over a relatively short period of time. Our key areas of focus include behavioral disease management, obesity management, and behavioral drug management, and in each of these areas we ended 2004 with products that we are ready to implement.

The initial suite of products comprises:

- *Condition Care Management: Behavioral Health*
- *Condition Care Management: Obesity*
- *Condition Care Management: Med/Psych Integration*
- *MagellanRx*

In January 2005, we successfully launched the first phase of our disease management products, *Condition Care Management: Behavioral Health*, which focuses on performing behavioral disease management. In addition, as I write this, we have formally launched our obesity product, *Condition Care Management: Obesity*, and are poised to market *MagellanRx*, our behavioral drug management offering. I am excited about the opportunities that these new products create and I am pleased that we are able to bring them to market in 2005.

## LOOKING AHEAD

I believe the health care market is at a pivotal stage and our goals for 2005 are geared toward positioning the company in a manner that allows us to capitalize on the new opportunities while maintaining and growing our core customer base and products.

We have seen, over the last year, increasing awareness among our health plan clients that managing behavioral care can be leveraged more broadly than it has been historically. Mental illness is idiosyncratic and, as a result, has historically been viewed separately from the world of traditional physical medicine. Today, however, there is growing awareness that behavior modification and management of behavioral change play a critical role in the treatment of both physical and mental illness.

We believe disease management, which focuses on changing patient behavior, creates tremendous opportunities to expand the breadth of our product line by leveraging our unique behavioral health care capabilities. At the same time, we recognize that we must maintain focus on our current customers and product line and demonstrate the value of our business proposition.

We are confident that, given our expertise in behavioral care, we can integrate the management of physical and behavioral care much more effectively than our customers could themselves. The key to our success from both a growth and a retention perspective is to be ahead of our customers in designing innovative products that address our customers' needs in a changing marketplace.

In 2005, we began bundling our existing behavioral care management product with our new products and we are working to secure long-term contracts that cover not only our core business but also expand the scope of our services into the new products. I am pleased to report that early interest in these products has been very good. I am very excited about our progress in these new areas and look forward to sharing more information with our shareholders as 2005 progresses.

Another significant initiative for 2005 will be our continued focus on capitalizing on opportunities in the Medicaid sector. Medicaid represents significant long-term growth potential for Magellan. As states face increasing pressure on their budgets and as Medicaid costs continue to increase at a rate that is disproportionate to that of other state spending, we anticipate seeing increased new business in this market. However, there is a very long sales cycle in this market, with the time between initial discussions about a new program and the actual award of a contract frequently spanning more than a year. In 2005 we will be bidding on new contracts and investing in establishing and maintaining relationships that we hope will yield contracts in the future.

Overall, the outlook for Magellan is very exciting. Our market, which a few years ago was somewhat stagnant, is now more dynamic. We have a proven management team with the talent and experience to capitalize on the opportunities before us. We have the cash and capital structure that will support our ability to move quickly and meaningfully into new opportunities. The management team is excited about the progress we have made and our prospects for the future. We are focused on success and are committed to delivering long-term value to both our customers and our shareholders.

Thank you for your continued support.

A handwritten signature in blue ink that reads "Steve Shulman". The signature is fluid and cursive, with the first name "Steve" and last name "Shulman" clearly distinguishable.

Steven J. Shulman

*Chairman and Chief Executive Officer*



Our innovative new products support our goal of managing a much greater share of the health care dollar.

– STEVEN J. SHULMAN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER



## WHAT IS YOUR LONG-TERM VISION FOR MAGELLAN?

My long-term vision is to leverage our core strategic assets into new and innovative products that allow us to manage a much greater share of the health care dollar than we do currently. These assets include our premier client base, a strong balance sheet, a management team with exceptional depth and breadth of experience in health care, and our unique asset – our expertise in behavioral care. We have worked diligently on new initiatives that leverage these strengths in a way that maximizes our future growth potential.

Historically, behavioral managed care has been carved out from the rest of medical care. Our new products, developed in 2004, are built on a behavioral foundation and are designed to seamlessly integrate and address both the behavioral and medical needs of individuals. Our initial product suite focuses on disease management for a number of conditions, including obesity, and behavioral pharmacy management. These new products supplement our current tools to create a more comprehensive approach to patient care management.

## TELL US ABOUT YOUR OBESITY MANAGEMENT PRODUCT. WHY WOULD MAGELLAN OFFER A PRODUCT LIKE THIS?

The U.S. spends \$117 billion annually on obesity and this spending drives up care costs for our customers. *Condition Care Management: Obesity* is designed to meet the need in the marketplace for strategies to address this problem. The product offers – based on an individual's body mass index or BMI – education, counseling and bariatric surgery management programs. For most people, the key to addressing obesity successfully is behavior modification. This is exactly where we have unique skills that can be leveraged.

## WHAT IS MAGELLANRx? HOW IS IT DIFFERENT FROM WHAT PHARMACY BENEFIT MANAGEMENT FIRMS DO?

Since 1997, costs associated with antipsychotic and antidepressive drugs have increased at rates far in excess of medication costs in general and pharmacy benefit management (PBM) firms have not been able to adequately focus on this problem. We believe that, with our dedicated clinical resources, we can *complement* a PBM's administrative and discounting capabilities and positively impact the cost of these medications while also encouraging their appropriate use in the treatment of behavioral health conditions.

Based on analysis of pharmacy data provided to us by several customers, we have determined that there are significant opportunities for us to reduce our customers' behavioral health pharmacy costs. We believe that in excess of 15 percent of these costs are attributable to prescribing practices that depart from standard clinical guidelines. MagellanRx is aimed at materially reducing such outlier prescribing through interventions targeted to both practitioners and members.

## WHAT IS THE TIMING OF THE NEW PRODUCT GROWTH?

Although our new products are in the early stages, I am very excited about their potential to expand the scope of our current portfolio and leverage our core strategic assets. I believe that we will begin to generate initial sales in 2006, but my expectation is that the earliest that we would start to experience a material impact on earnings would probably be 2007.



We have already demonstrated significantly improved effectiveness over standard disease management practices.

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

**STEVE MENTIONED THAT THE COMPANY IS MOVING INTO DISEASE MANAGEMENT. WHAT EXACTLY ARE YOU DOING?**

In January 2005 we launched *Condition Care Management: Behavioral Health*, a disease management program initially focused on reducing the cost of behavioral care for those patients likely to be our highest users of service. Seven behavioral conditions generate 82 percent of our costs. This new product uses predictive modeling to identify high-risk, and therefore potentially high-cost, patients and reach-and-engage disease management techniques to enhance the management of care. We reach out to our high-risk patients early in the course of their illness and, by proactively working with them, we strive to further improve the quality of their care and reduce their need for hospitalization. We anticipate having approximately 7 million members in the program by the end of 2005.

*Condition Care Management: Behavioral Health* serves several strategic purposes. As I have stated, it can help us to reduce behavioral health care costs and will also be a source of new non-risk revenues. In addition, it demonstrates new value and innovation to our customers that would be difficult for them to realize on their own. Perhaps as importantly, this product serves a key role in repositioning the company by providing us with the platform and experience necessary to expand into additional areas of disease management in the future.

**DOES THIS MEAN YOU INTEND TO MOVE INTO MEDICAL DISEASE MANAGEMENT?**

Yes. Our *Condition Care Management: Med/Psych Integration* product is designed to integrate the management of behavioral and medical care. By improving a patient's mental status we can increase compliance with his or her medical treatment regimen, effect lifestyle changes to promote greater self-management of disease states and decrease overall costs associated with a patient's illness. Based on pilots developed and operated in 2004, we have

demonstrated medical cost reductions for chronically ill medical patients with a concurrent psychological condition for whom we have co-managed care through targeted behavioral case management. Most importantly, we demonstrated a greater reduction in medical costs for patients whose care was managed through our program than was realized for a control group managed with standard disease management protocols. We are very excited about the results that have been coming out of our pilot work in this area and we feel that the co-management of behavioral and medical care represents the next evolution of our products.

**HOW IS YOUR PRODUCT DIFFERENT FROM WHAT IS CURRENTLY IN THE MARKET?**

We have begun to demonstrate that we can drive greater savings than traditional disease management protocols are achieving today by leveraging our expertise in behavioral modification. Ultimately disease management is focused on changing patients' behavior in a way that will improve their health status. Disease progression and complications are often avoided or slowed by encouraging members with chronic illnesses to learn more about their illness, take medications as prescribed, stay on health and nutrition regimes, avoid high-risk activities and be better consumers of health care. Current disease management practices are primarily focused on reminding patients to comply with their doctors' treatment plans as well as change their underlying lifestyles. However, we believe that most non-compliance is driven by other, deeper psychological issues. With our expertise in behavioral care and modification, we believe that we will be able to identify and treat the root causes of non-compliance, such as depression and denial, and educate patients more effectively about their diseases. Through the successful identification and treatment of these root causes, we have already been able to demonstrate significantly improved effectiveness over standard disease management practices.



We are committed to maximizing our capital structure in a manner that supports our strategic and financial goals.

– MARK S. DEMILIO, CHIEF FINANCIAL OFFICER

## **MAGELLAN ENTERED 2005 WITH \$355 MILLION IN UNRESTRICTED CASH AND INVESTMENTS.**

### **WHAT WILL THE COMPANY DO WITH THAT CASH?**

We are committed to maximizing our capital structure in a manner that supports our strategic and financial goals and we continually evaluate our opportunities and execute our decisions based on that objective.

We are very interested in acquisitions and, although we are currently building a disease management platform, we continue to investigate opportunities to acquire a company that would accelerate our expansion into that market. We also are interested in acquisitions of competitors. Of course, the success of any such effort depends on completing a smart, strategic acquisition at the right price. We are very disciplined in our review and are committed to only making acquisitions that meet both our strategic and financial criteria.

While acquisitions are our preferred use of cash, we continue to explore other options for the most efficient use of our growing unrestricted cash and investments balance. In addition to considering acquisitions, we continue to evaluate whether to call or refinance our Senior Notes and whether to institute a share repurchase.

### **WHAT TYPE OF DISEASE MANAGEMENT ACQUISITION WOULD MAGELLAN BE INTERESTED IN?**

Given our strong financial position, we have the ability to consider a fairly wide range of deals. In the disease management area we would consider privately held companies that have strong core capabilities. Our goal would be to acquire a company and then integrate our own unique behavioral management capabilities with its medical disease management protocols – creating what we believe will be the next generation of disease management.

This strategy would enable us to expand our current capabilities and then market a full-scale, integrated disease management product to our existing customer base. We have excellent customer relationships that we believe we will be able to leverage to expand into a disease management product.

### **WHAT IS THE TIMING FOR MAKING AN ACQUISITION OR A CHANGE TO YOUR CAPITAL STRUCTURE?**

We are actively looking at acquisition opportunities and expect to continue to do so during the remainder of 2005. Due to our review of potential acquisitions, we do not anticipate making other decisions on our capital structure until late in the year.

It is important to remember that evaluating potential acquisitions can take some time. It is common to consider many potential deals before finding a good fit. Timing will also be driven somewhat by the opportunities that present themselves. We are very disciplined in our approach and will only make an acquisition if and when we identify an opportunity that meets our criteria.

How much, if any, cash we spend on an acquisition will impact other decisions related to our capital structure, including other potential acquisitions or investments, repayment or refinancing of our debt, or a stock repurchase. Our \$240 million of 9<sup>3</sup>/<sub>8</sub>% Senior Notes are callable in November 2005. We anticipate that we would either refinance or pay off those notes in 2005.

Given our strong balance sheet, the capital structure alternatives I have discussed are not mutually exclusive. We will continue our holistic review of our opportunities and look forward to updating shareholders on any developments throughout the year.

# 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*

Christopher W. Cooney

*Chief Branding and Communications Officer*

Jeff D. Emerson

*Chief Information Officer*

Daniel N. Gregoire

*Chief Legal Officer/General Counsel and Secretary*

Anthony M. Kotin

*Chief Marketing and Strategy Officer*

Caskie Lewis-Clapper

*Chief Human Resources Officer*

Alex Rodriguez, M.D.

*Chief Medical Officer*

## BOARD OF DIRECTORS

Steven J. Shulman

*Chairman and Chief Executive Officer*

MAGELLAN HEALTH SERVICES, INC.

Robert M. Le Blanc

*Managing Director*

ONEX CORPORATION

Saul E. Burian

*Managing Director*

HOULIHAN LOKEY HOWARD & ZUKIN

Michael Diament

*Portfolio Manager and Director of Bankruptcies  
and Restructurings*

RENEGADE SWISH, LLC

Robert Haft

*Principal Manager*

MORGAN NOBLE, LLC

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. Ressner

*Adjunct Professor of Finance and Accounting*

NORTH CAROLINA STATE UNIVERSITY

Barry M. Smith

*Founder, Chairman and Chief Executive Officer*

BON TRAVAY, S.A.

# SHAREHOLDER INFORMATION

## WEB SITE

[www.MagellanHealth.com](http://www.MagellanHealth.com)

## TRANSFER AGENT

Wachovia Bank, N.A.

1525 West W.T. Harris Blvd., 3C3

Charlotte, NC 28262-8522

Toll Free: 800-829-8432

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](http://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](mailto:ir@magellanhealth.com).

## ANNUAL MEETING

Magellan's annual shareholder meeting will be held on May 18, 2005 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 "Cautionary Statements" in Magellan's Annual Report on Form 10-K for the year ended December 31, 2004 attached herein.



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