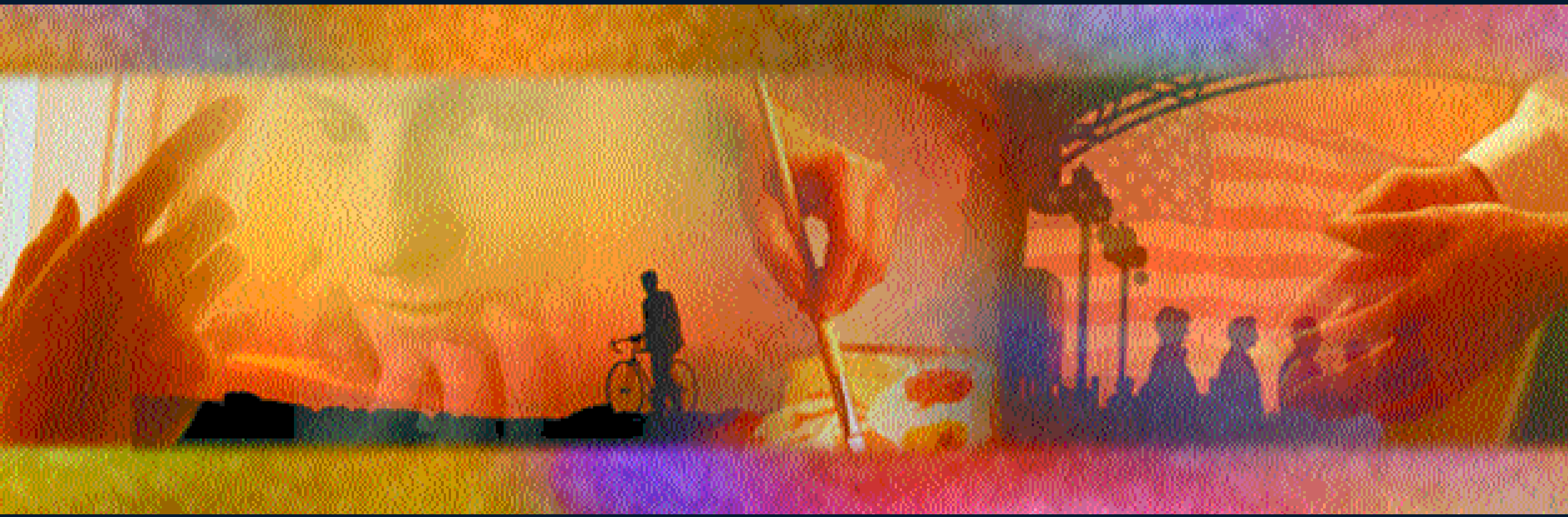
Magellan Health Services



2001 ANNUAL REPORT

Magellan Health Services extends its gratitude to the many Magellan employees and behavioral health practitioners who exhibited remarkable dedication and compassion in helping the individuals and companies affected by the terrible events of September 11th, 2001. In recognition of their extraordinary service, the company has donated a portion of the dollars budgeted for this annual report to September 11th relief efforts.

financial highlights

(in millions except per share amounts)

Fiscal years ended September 30.

	2001	2000
REVENUES	$ 1,755.5	$ 1,640.9
SEGMENT PROFIT	$ 235.0	$ 208.6
INCOME FROM CONTINUING OPERATIONS AVAILABLE TO COMMON SHAREHOLDERS	$ 33.3	$ 8.6
INCOME FROM CONTINUING OPERATIONS AVAILABLE TO COMMON SHAREHOLDERS PER DILUTED SHARE	$ 0.81	$ 0.15
CASH FLOW FROM OPERATIONS	$ 85.7	$ 106.9
COVERED LIVES	69.6	71.0
DEBT OUTSTANDING	$ 1,006.4	$ 1,098.0

These financial highlights should be read in conjunction with the complete financial statements and with Management's Discussion and Analysis of Financial Condition and Results of Operations which appear in the Company's Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission on December 31, 2001.

We have made great progress in the last year in working toward establishing Magellan as a world-class managed behavioral health care organization.

letter from the chairman

Fiscal year 2001 was a year of transitions - for our company, our industry and for me personally. Without a doubt, we achieved our goal to focus exclusively on our managed behavioral health and EAP business, the segment of our business that had historically shown the most consistent performance and greatest potential for growth. Last year was truly a transitional year as we completed our divestitures of the specialty health division, National MENTOR and our physician practice management business. Having exited these segments, we were able to turn our full attention to our flagship business and direct our efforts toward enhancing operations, improving service, and positioning the company for long-term growth, as well as enhancing the company's financial position. The improvement in Magellan's financial stability in the last year is proof of the wisdom of this action and I am pleased that we were able to accomplish these divestitures this past year.

Last year marked a transition year for the mental health field and the managed behavioral health care industry as well, as the importance of mental health care in our society was showcased in a manner that was unprecedented. Tragically, our nation became more aware of the value of behavioral health care as a result of the truly awful events of September 11th. Not only individuals, but entire organizations came to realize the role that mental health care and employee assistance program services could play in helping thousands of people cope with these traumatic events. Rather than being seen as a luxury benefit, our nation realized the necessity of the services that behavioral health practitioners and companies like Magellan provide.

We also saw unprecedented national attention paid to the issue of mental health parity.

In July I had the honor of testifying before a committee of the United States Senate on behalf of Magellan and our industry trade group in support of expanded federal parity legislation. Our entire industry was mobilized in an effort to educate Congress that the time had come to provide comprehensive mental health benefits on a par with benefits for physical health care and that our nation could accomplish this with only modest cost increases. Even before September 11th, this legislation had broad bipartisan support in Congress, yet it ultimately failed in the face of more pressing concerns about the economy and other issues. Nonetheless, never before has federal parity legislation garnered the national attention and political support that it did in last year's session. Moving into 2002, we are very confident that the mental health community - our industry included - can build upon the successes of 2001 and that Congress will pass expanded legislation. In fact, as I write this, I am buoyed by the news that President Bush has indicated his desire to work with Congress to find ways to make more comprehensive mental health benefits available while also managing costs.

Finally, 2001 marked a transition for me personally. Early in the year I took on the role of chairman of the board, in addition to my role as CEO, while my friend and colleague, Dan Messina, became president. After joining the company the previous year, Dan quickly demonstrated his commitment and value to Magellan and to me and was instrumental in the tremendous progress we made in 2001. I was very pleased, in the closing days of our fiscal year, to turn Magellan's helm over to him as he assumed the role of CEO.

Magellan has a strong management team and board of directors and I have great confidence that we have the talent and expertise necessary to be successful in fiscal year 2002 and beyond. This transition now allows me to build on my more than 10 years in the managed behavioral health care industry and more than 20 years in mental health care through a more active role in public policy issues such as parity, while continuing an active role within Magellan to provide support and counsel to Dan and the board on strategic initiatives in the industry, as well as support with key customers.

We have made great progress in the last year in working toward establishing Magellan as a world-class managed behavioral health care organization. This progress would not have been possible without the patience and support of our shareholders, and for that I am very appreciative. While we have work yet to do, we are a stronger, more stable organization with excellent prospects for the future and I look forward to our continued success.

Sincerely,

Henry Harbin

Henry T. Harbin, M.D.
Chairman

Our plan is to continually rationalize and re-engineer to create the most efficient organization with the best cost structure possible in order to be a healthy and sustainable organization moving forward.

letter from the president & ceo

As we entered fiscal year 2001, we knew we had a lot of challenges to face. We knew we had to dramatically improve the company's financial flexibility. We recognized the need to focus on our core behavioral business and to address a number of service issues in that operation. We knew we needed to enhance the depth and experience of our management team and revamp our book of business to position it for long-term growth. And we understood we had to continue with our long-term reengineering program to change the way we do business, improve our service to members and customers, and dramatically reduce our costs to take full advantage of our size.

With a lot of hard work, we have addressed most of these significant issues. Through our refinancing efforts and the sale of Mentor and other assets, we reduced our debt and dramatically improved our future liquidity. We also continued to strenghten our discipline with respect to our pricing and renewal strategy and have carefully evaluated and made sound decisions about whether to continue in problematic accounts.

We were able to focus our attention on our behavioral business. That focus has paid off in solid improvements in service. Any successful turnaround begins with a strong operational backbone and, clearly, we made great strides in this regard in fiscal year 2001. Our claims backlog, average turnaround time, average speed of answer and abandonment rate are all equal to or exceed industry standards.

We believe that our call center metrics lead the industry in customer service and speed of response. And, our member surveys continue to show satisfaction rates exceeding the 90 percent mark.

Our customers care most about our ability to meet their complex needs with superb reliability and service. Our business, like every business, is competitive, so price is important, but we believe that continued emphasis on quality service and reliability will sustain our growth. While our customers demand reliability and quality service, they also demand a simple, 'hassle-free' environment for their employees and members, as well as the practitioners who treat them, and this remains a priority for the company. In this regard, we are focusing on three areas - responding to member inquiries quickly and efficiently, paying practitioners accurately and on a timely basis, and reaching out to practitioners to listen to their feedback, understand their issues, and work collaboratively to address them.

Certainly, the improvements we have made in service have positively affected our members and customers. Looking ahead, we will continue to leverage technology to better identify and capture data, making it more readily available to our care managers, providers and members. In addition, we will strive to provide more hands-on care management for those who need it most, focusing our efforts where we can have the greatest positive impact for our members and customers.

Similarly, the strides we have made in reducing our claims backlog and turnaround time are a significant step in the right direction in terms of timely payment to practitioners. And, we have already begun to enhance the communication channels with the practitioners in our network to share industry observations, benchmarks and best practices. We will also further utilize our Internet capabilities, seeking to reduce administrative costs for our providers.

We made changes to our management team and now have more experience, greater depth and additional commitment among the senior managers. Furthermore, the executive team is now aligned in a manner that allows a more streamlined approach to decision-making, which is essential as we move forward with strategic changes to improve the company's overall position. Magellan has the management talent to lead this company through the remainder of its turn-around, as well as a management structure that allows us to be agile and responsive in the marketplace.

Looking ahead, fundamental demand for sophisticated mental health management is increasing from employers and government. The continued consolidation of our health plan customers has created a demand for comprehensive product offerings that are available on a national basis. Our accomplishments this past year on improving service and reducing the 'hassle factor', along with our e-commerce initiatives, new product offerings and provider network recontracting, mean that our prospects for retaining our existing customers and growing our business remain favorable.

While federal mental health parity legislation was not enacted by Congress in 2001, as your chairman Henry Harbin noted, it made greater progress in this session than it ever has in the past and we are hopeful that it will pass in the coming year. Yet, regardless of the ultimate outcome of parity legislation, the trend of providing more comprehensive mental health benefits continues, and therefore a greater need for management of those benefits is undeniable.

Certainly, our ability to retain and expand the business is the bedrock of sustained earnings growth, but there are a number of other factors that Magellan is focusing on as well to achieve this growth.

Managing administrative costs, realizing additional operating efficiencies and making continued improvements in service are also key to our sustained growth. Despite the priority we placed on devoting resources to improving service in 2001, the company's expense ratio decreased from last year. While we still have work to do on this front, this progress is significant. We will continue our system migration efforts - an essential component of our plan to achieve greater operating efficiencies - and are on track to complete the migration by the end of 2003. We will also continue our efforts to move toward a single database for our provider network and our membership and expect this to be completed in early 2003.

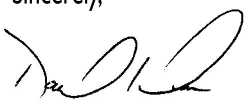
Despite the prospects for the future, we recognize that the hard work is not over. To be a healthy, viable company that can sustain growth over time, we have to ask difficult questions about how we conduct business and take actions today to respond to our internal and external pressures. In this ever-changing business environment, Magellan cannot afford to be a reactive company. We must be acutely aware of market trends and proactively position ourselves for success. Challenging the way we have always done business and the way we are structured to carry out that business is essential in this endeavor.

Our plan is to continually rationalize and re-engineer to create the most efficient organization with the best cost structure possible in order to be a healthy and sustainable organization moving forward. Given our size and scale, we expect to be able to accomplish our goal of quality, 'hassle-free' service and the most efficient cost structure in the industry.

As we moved into fiscal year 2002, I laid out a vision for Magellan to be the leader in our industry, not just in size, but also in product enhancement, customer service and employee engagement. Achievement of this vision will allow us to best serve our key constituents: our members, our customers, our providers, our shareholders and our employees.

As our fiscal year was drawing to a close, our nation experienced one of the most horrific events of its history and the world has become a very different place as a result. The World Trade Center and Pentagon attacks and the war against terrorism have significantly altered the environment in which we all live and work. Yet, in many respects, these trying times have been an opportunity for Magellan to demonstrate its leadership role as we help the nation cope with tragedy and fear. I am extremely proud of our performance during this critical time and feel a great deal of personal gratitude toward our employees and toward behavioral health practitioners around the country for their willingness to give 110 percent in the service of our members and customers. What we accomplished in the weeks and months after September 11th reinforced for me the commitment and dedication of the more than 6,000 people who work for Magellan Health Services. It is this commitment and dedication that has helped us to address many of the difficult issues facing our company over the last year and will enable us to meet the challenge of continuing Magellan's transformation into a world-class managed behavioral health care organization as we move into 2002.

Sincerely,



Daniel S. Messina
President and Chief Executive Officer

consolidated statements of operations

Fiscal years ended September 30,	*(in thousands, except per share amounts)* 2001	2000
Net revenue	$ 1,755,512	$ 1,640,933
Costs and expenses:		
Salaries, cost of care and other operating expenses	1,557,042	1,442,082
Equity in earnings of unconsolidated subsidiaries	(36,566)	(9,792)
Depreciation and amortization	68,294	68,261
Interest, net	93,662	97,286
Special charges	3,340	25,398
	1,685,772	1,623,235
Income from continuing operations before income taxes, minority interest and extraordinary item	69,740	17,698
Provision for income taxes	36,388	8,994
Income from continuing operations before minority interest and extraordinary item	33,352	8,704
Minority interest	78	114
Income from continuing operations before extraordinary item	33,274	8,590
Discontinued operations:		
Income (loss) from discontinued operations (1)	4,624	(56,736)
Loss on disposal of discontinued operations (2)	(9,359)	(17,662)
	(4,735)	(74,398)
Income (loss) before extraordinary item	28,539	(65,808)
Extraordinary item - net loss on early extinguishment of debt (net of income tax benefit of $2,656 in fiscal 2001)	(3,984)	—
Net income (loss)	24,555	(65,808)
Preferred dividend requirement and amortization of redeemable preferred stock issuance costs	5,049	3,802
Income (loss) available to common stockholders	19,506	(69,610)
Other comprehensive income (loss)	(68)	(102)
Comprehensive Income (loss)	$ 19,438	$ (69,712)
Weighted average number of common shares outstanding - basic	33,448	32,144
Weighted average number of common shares outstanding - diluted	41,235	32,386
Income (loss) per common share available to common stockholders - basic:		
Income from continuing operations before extraordinary item	$ 0.84	$ 0.15
Loss from discontinued operations	$ (0.14)	$ (2.32)
Extraordinary loss on early extinguishment of debt	$ (0.12)	$ —
Net income (loss)	$ 0.58	$ (2.17)
Income (loss) per common share available to common stockholders - diluted:		
Income from continuing operations before extraordinary item	$ 0.81	$ 0.15
Loss from discontinued operations	$ (0.11)	$ (2.30)
Extraordinary loss on early extinguishment of debt	$ (0.10)	$ —
Net income (loss)	$ 0.60	$ (2.15)

(1) Net of income tax provision (benefit) of $25,450, $(27,577) and $2,921 for fiscal 1999, 2000 and 2001, respectively.

(2) Net of income tax provision (benefit) of $(31,616), $(9,224) and $10,781 for fiscal 1999, 2000 and 2001, respectively.

These condensed financial statements should be read in conjunction with the complete financial statements and with Management's Discussion and Analysis of Financial Condition and Results of Operations which appear in the Company's Annual Report on form 10-K, which was filed with the Securities and Exchange Commission on December 31, 2001.

consolidated statements of cash flows

Fiscal years ended September 30,	*(in thousands)* 2001	2000
Cash Flows From Operating Activities		
Net income (loss)	$ 24,555	$ (65,808)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
(Gain) loss on sale of assets	1,918	(2,442)
Depreciation and amortization	70,277	79,244
Impairment of long-lived assets	—	91,015
Equity in earnings of unconsolidated subsidiaries	(36,566)	(9,792)
Stock option expense	636	—
Non-cash interest expense	5,078	4,376
Extraordinary loss on early extinguishment of debt	3,984	—
Cash flows from changes in assets and liabilities, net of effects from sales and acquisitions of businesses:		
Accounts receivable, net	(6,881)	63,057
Restricted cash and investments	(4,725)	(899)
Distributions received from unconsolidated subsidiaries	38,353	14,324
Other assets	2,754	(8,246)
Accounts payable and accrued liabilities	(37,739)	(37,081)
Medical claims payable	(11,310)	19,767
Income taxes payable and deferred income taxes	47,698	(31,089)
Reserve for unpaid claims	—	(78)
Other liabilities	(13,402)	(8,361)
Minority interest, net of dividends paid	130	(1,010)
Other	926	(102)
Total adjustments	61,131	172,683
Net cash provided by operating activities	85,686	106,875
Net cash used in investing activities	(11,889)	(102,435)
Net cash (used in) provided by financing activitiess	(93,088)	5,627
Net (decrease) increase in cash and cash equivalents	(19,291)	10,067
Cash and cash equivalents at beginning of period	47,507	37,440
Cash and cash equivalents at end of period	$ 28,216	$ 47,507

These condensed financial statements should be read in conjunction with the complete financial statements and with Management's Discussion and Analysis of Financial Condition and Results of Operations which appear in the Company's Annual Report on form 10-K, which was filed with the Securities and Exchange Commission on December 31, 2001.

consolidated balance sheets

Fiscal years ended September 30,	*(in thousands, except per share amounts)* 2001	2000
Assets		
Current Assets:		
Cash and cash equivalents	$ 28,216	$ 47,507
Accounts receivable	103,642	137,224
Restricted cash and investments	122,448	117,723
Refundable income taxes	1,741	4,416
Other current assets	17,964	18,662
Total current assets	274,011	325,532
Property and equipment, net	94,322	112,612
Deferred income taxes, net	81,558	121,782
Investments in unconsolidated subsidiaries	10,899	12,746
Other long-term assets	24,813	10,235
Goodwill, net	1,033,329	1,074,753
Other intangible assets, net	147,773	152,006
	$ 1,666,705	$ 1,809,666
Liabilities and Stockholders' Equity		
Current Liabilities:		
Accounts payable	$ 23,765	$ 46,566
Accrued liabilities	193,243	175,698
Medical claims payable	209,214	219,375
Current maturities of long-term debt and capital lease obligations	4,063	34,119
Total current liabilities	430,285	475,758
Long-term debt and capital lease obligations	1,002,293	1,063,928
Deferred credits and other long-term liabilities	8,694	83,226
Minority interest	563	456
Commitments and Contingencies		
Redeemable preferred stock	62,682	57,834
Stockholders' Equity:		
Preferred stock without par value		
Common stock, par value $.25 per share	9,238	8,733
Other Stockholders' Equity		
Additional paid-in capital	358,273	349,541
Accumulated deficit	(185,803)	(210,358)
Warrants outstanding	25,050	25,050
Common stock in treasury	(44,309)	(44,309)
Cumulative foreign currency adjustments included in other comprehensive income	(261)	(193)
Total stockholders' equity	162,188	128,464
	$ 1,666,705	$ 1,809,666

These condensed financial statements should be read in conjunction with the complete financial statements and with Management's Discussion and Analysis of Financial Condition and Results of Operations which appear in the Company's Annual Report on form 10-K, which was filed with the Securities and Exchange Commission on December 31, 2001.

directors and officers

Directors

Henry T. Harbin, M.D.
Chairman

David Bonderman
Managing Director, Founding Partner
Texas Pacific Group

Jonathan J. Coslet
Senior Partner
Texas Pacific Group

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

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

A.D. Frazier, Jr.
President and Chief Executive Officer
Chicago Stock Exchange

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

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

Robert W. Miller, Esq.
Retired Managing Partner
King & Spalding

Darla D. Moore
President
Rainwater, Inc.

Jeffrey A. Sonnenfeld
President & CEO
The Chief Executive Leadership Institute, Inc.
Associate Dean, Executive Programs
Yale School of Management

James B. Williams
Partner
Texas Pacific Group

Officers

Daniel S. Messina
President and Chief Executive Officer

Megan M. Arthur
Executive Vice President,
General Counsel, Corporate Secretary

William C. Barr
Executive Vice President,
Workplace Group

Gregory A. Bayer, Ph.D.
Executive Vice President,
Operations & Information Technology

Jonathan D. Book, M.D.
Executive Vice President,
Chief Medical Officer
Magellan Behavioral Health

Mark S. Demilio
Executive Vice President,
Chief Financial Officer

Caskie Lewis-Clapper
Executive Vice President,
Human Resources

Dennis P. Moody
Executive Vice President,
Business Operations

Deborah L. Trout, Ph.D.
Executive Vice President,
Chief Clinical Officer
Magellan Behavioral Health

shareholder information

Executive Headquarters
Magellan Health Services, Inc.
6950 Columbia Gateway Drive
Columbia, MD 21046

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

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

Annual Shareholders' Meeting
The annual meeting of shareholders of Magellan Health Services, Incorporated will be held at The Harbor Court Hotel, 550 Light Street, Baltimore, MD 21203, at 10:00 a.m. EST on February 28, 2002

Trustee For
9% Series A Senior Subordinated Notes due 2008
HSBC Bank USA
Issuer Services
452 Fifth Avenue
New York, NY 10018-2706
Telephone: 212-525-1316

9.375% Senior Notes due 2008
HSBC Bank USA
Issuer Services
452 Fifth Avenue
New York, NY 10018-2706
Telephone: 212-525-1316

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

Investor Information
Requests for Magellan's financial documents and additional queries may be directed to:
Melissa L. Rose
Vice President, Investor Relations
Magellan Health Services, Inc.
6950 Columbia Gateway Drive
Columbia, MD 21046
Telephone: 877-MGL-6464

Investor information, including audio archives of recent conference calls and upcoming investor presentation dates, can be found on the investor relations page at www.magellanhealth.com

Magellan Health Services

MAGELLAN HEALTH SERVICES
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COLUMBIA, MARYLAND 21046