MAGELLAN HEALTH INC
Form 10-Q
April 26, 2017
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10 Q

(Mark One)

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

For the Quarterly Period Ended March 31, 2017

Or

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, 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.)
4800 N. Scottsdale Rd, Suite 4400 Scottsdale, Arizona (Address of principal executive offices)	85251 (Zip code)

(602) 572 6050

(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 No

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 No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non accelerated filer, smaller reporting company, or an emerging growth company. See definition of “large accelerated filer”, “accelerated filer”, “smaller reporting company” and “emerging growth company” in Rule 12b 2 of the Exchange Act. (Check one):

Large accelerated filer	Accelerated filer	Non accelerated filer (Do not check if a smaller reporting company)
Smaller reporting company		Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange

Act.

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

The number of shares of the registrant’s Ordinary Common Stock outstanding as of March 31, 2017 was 23,717,121.

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MAGELLAN HEALTH, INC. AND SUBSIDIARIES

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PART I—FINANCIAL INFORMATION

Item 1. Financial Statements.

MAGELLAN HEALTH, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands, except per share amounts)

	December 31, 2016	March 31, 2017 (Unaudited)
ASSETS		
Current Assets:		
Cash and cash equivalents (restricted balances of $81,776 and $73,272 at December 31, 2016 and March 31, 2017, respectively)	$ 304,508	$ 273,587
Accounts receivable, less allowance for doubtful accounts of $5,644 and $6,171 at December 31, 2016 and March 31, 2017, respectively	606,764	634,102
Short-term investments (restricted balances of $227,795 and $220,284 at December 31, 2016 and March 31, 2017, respectively)	297,493	306,549
Pharmaceutical inventory	58,995	62,374
Other current assets (restricted balances of $38,785 and $34,002 at December 31, 2016 and March 31, 2017, respectively)	51,507	52,717
Total Current Assets	1,319,267	1,329,329
Property and equipment, net	172,524	166,536
Long-term investments (restricted balances of $6,306 and $5,699 at December 31, 2016 and March 31, 2017, respectively)	7,760	7,151
Deferred income taxes	3,125	4,507
Other long-term assets	12,725	15,709
Goodwill	742,054	742,775
Other intangible assets, net	186,232	177,054
Total Assets	$ 2,443,687	$ 2,443,061
LIABILITIES, REDEEMABLE NON-CONTROLLING INTEREST AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 95,635	$ 82,385
Accrued liabilities	202,176	165,632
Short-term contingent consideration	9,354	9,761
Medical claims payable	184,136	174,302
Other medical liabilities	197,856	202,533
Current debt and capital lease obligations	403,693	428,795
Total Current Liabilities	1,092,850	1,063,408
Long-term debt and capital lease obligations	214,686	207,549
Tax contingencies	13,981	14,764
Long-term contingent consideration	1,799	1,343
Deferred credits and other long-term liabilities	15,882	20,032
Total Liabilities	1,339,198	1,307,096

Redeemable non-controlling interest	4,770	4,492
Preferred stock, par value $.01 per share		
Authorized—10,000 shares at December 31, 2016 and March 31, 2017-Issued and outstanding-none	—	—
Ordinary common stock, par value $.01 per share		
Authorized—100,000 shares at December 31, 2016 and March 31, 2017-Issued and outstanding-51,993 shares and 23,517 shares at December 31, 2016, respectively, and 52,193 and 23,717 shares at March 31, 2017, respectively	520	522
Multi-Vote common stock, par value $.01 per share		
Authorized—40,000 shares at December 31, 2016 and March 31, 2017-Issued and outstanding-none	—	—
Other Stockholders' Equity:		
Additional paid-in capital	1,186,283	1,200,309
Retained earnings	1,289,288	1,307,035
Accumulated other comprehensive loss	(175)	(196)
Ordinary common stock in treasury, at cost, 28,476 shares and 28,476 shares at December 31, 2016 and March 31, 2017, respectively	(1,376,197)	(1,376,197)
Total Stockholders' Equity	1,099,719	1,131,473
Total Liabilities, Redeemable Non-Controlling Interest and Stockholders' Equity	$ 2,443,687	$ 2,443,061

See accompanying notes to consolidated financial statements.

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MAGELLAN HEALTH, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME (LOSS)

(Unaudited)

(In thousands, except per share amounts)

	Three Months Ended March 31, 2016	2017
Net revenue:		
Managed care and other	$ 676,461	$ 729,340
PBM and dispensing	440,561	576,283
Total net revenue	1,117,022	1,305,623
Costs and expenses:		
Cost of care	457,631	482,054
Cost of goods sold	415,459	542,633
Direct service costs and other operating expenses (1)(2)	192,456	221,486
Depreciation and amortization	25,007	26,976
Interest expense	1,748	4,148
Interest and other income	(683)	(949)
Total costs and expenses	1,091,618	1,276,348
Income before income taxes	25,404	29,275
Provision for income taxes	12,013	11,806
Net income	13,391	17,469
Less: net income (loss) attributable to non-controlling interest	154	(278)
Net income attributable to Magellan Health, Inc.	$ 13,237	$ 17,747
Net income per common share attributable to Magellan Health, Inc.:		
Basic (See Note B)	$ 0.56	$ 0.77
Diluted (See Note B)	$ 0.54	$ 0.74

(1) Includes stock compensation expense of $8,887 and $10,140 for the three months ended March 31, 2016 and 2017, respectively.

(2) Includes changes in fair value of contingent consideration of $(266) and $(49) for the three months ended March 31, 2016 and 2017, respectively.

See accompanying notes to consolidated financial statements.

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MAGELLAN HEALTH, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Unaudited)

(In thousands)

	Three Months Ended March 31,	
	2016	2017
Net income	$ 13,391	$ 17,469
Other comprehensive income (loss):		
Unrealized gains (losses) on available-for-sale securities (1)	238	(21)
Comprehensive income	13,629	17,448
Less: comprehensive income (loss) attributable to non-controlling interest	154	(278)
Comprehensive income attributable to Magellan Health, Inc.	$ 13,475	$ 17,726

(1) Net of income tax provision (benefit) of $146 and $(12) for the three months ended March 31, 2016 and 2017, respectively.

See accompanying notes to consolidated financial statements.

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MAGELLAN HEALTH, INC. AND SUBSIDIARIESCONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE THREE MONTHS ENDED MARCH 31,

(Unaudited)

(In thousands)

	2016	2017
Cash flows from operating activities:		
Net income	$ 13,391	$ 17,469
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	25,007	26,976
Non-cash interest expense	102	253
Non-cash stock compensation expense	8,887	10,140
Non-cash income tax benefit	(538)	(1,010)
Non-cash amortization on investments	1,844	1,112
Cash flows from changes in assets and liabilities, net of effects from acquisitions of businesses:		
Accounts receivable, net	(13,538)	(27,699)
Pharmaceutical inventory	(5,121)	(3,379)
Other assets	(35,839)	(1,172)
Accounts payable and accrued liabilities	11,406	(52,838)
Medical claims payable and other medical liabilities	(38,292)	(5,160)
Contingent consideration	734	(49)
Tax contingencies	289	506
Deferred credits and other long-term liabilities	(227)	4,150
Other	34	(421)
Net cash used in operating activities	(31,861)	(31,122)
Cash flows from investing activities:		
Capital expenditures	(15,611)	(10,939)
Acquisitions and investments in businesses, net of cash acquired	(15,641)	(200)
Purchase of investments	(157,020)	(141,432)
Maturity of investments	144,902	131,840
Net cash used in investing activities	(43,370)	(20,731)
Cash flows from financing activities:		
Proceeds from issuance of debt	—	200,000
Payments to acquire treasury stock	(7,992)	—
Proceeds from exercise of stock options and warrants	7,784	4,945
Payments on debt and capital lease obligations	(4,154)	(182,738)
Payments on contingent consideration	(2,000)	—
Other	(72)	(1,275)
Net cash (used in) provided by financing activities	(6,434)	20,932
Net decrease in cash and cash equivalents	(81,665)	(30,921)
Cash and cash equivalents at beginning of period	249,029	304,508
Cash and cash equivalents at end of period	$ 167,364	$ 273,587

Supplemental cash flow data:		
Non-cash investing activities:		
Property and equipment acquired under capital leases	$ 1,293	$ 906

See accompanying notes to consolidated financial statements.

MAGELLAN HEALTH, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March, 31 2017

(Unaudited)

NOTE A—General

Basis of Presentation

The accompanying unaudited consolidated financial statements of Magellan Health, Inc., a Delaware corporation (“Magellan”), include Magellan and its subsidiaries (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 months ended March 31, 2017 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.

These unaudited consolidated financial statements should be read in conjunction with the Company’s audited consolidated financial statements for the year ended December 31, 2016 and the notes thereto, which are included in the Company’s Annual Report on Form 10-K filed with the SEC on February 24, 2017.

Business Overview

The Company is engaged in the healthcare management business, and is focused on managing the fastest growing, most complex areas of health, including special populations, complete pharmacy benefits and other specialty areas of healthcare. The Company develops innovative solutions that combine advanced analytics, agile technology and clinical excellence to drive better decision making, positively impact health outcomes and optimize the cost of care for the members we serve. The Company provides services to health plans and other managed care organizations (“MCOs”), employers, labor unions, various military and governmental agencies and third party administrators (“TPAs”).

Healthcare

Healthcare includes the Company’s: (i) management of behavioral healthcare services and employee assistance program (“EAP”) services, (ii) management of other specialty areas including diagnostic imaging and musculoskeletal management, and (iii) the integrated management of physical, behavioral and pharmaceutical healthcare for special populations, delivered through Magellan Complete Care (“MCC”). These special populations include individuals with serious mental illness (“SMI”), dual eligibles, long term services and supports and other populations with unique and often complex healthcare needs.

The Company’s coordination and management of these healthcare services are provided through its comprehensive network of medical and behavioral health professionals, clinics, hospitals and ancillary service providers. This network of credentialed and privileged providers is integrated with clinical and quality improvement programs to improve access to care and enhance the healthcare experience for individuals in need of care, while at the same time making the cost of these services more affordable for our customers. The Company generally does not directly provide or own any provider of treatment services, although it does employ licensed behavioral health counselors to deliver non medical counseling under certain government contracts.

The Healthcare segment's commercial division serves a variety of customers, with services, inclusive of special population management, provided under contracts with health plans and accountable care organizations for some or all of their commercial, Medicaid and Medicare members, as well as with employers. The government division contracts with local, state and federal governmental agencies to provide services to recipients under Medicaid, Medicare and other government programs.

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MAGELLAN HEALTH, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March, 31 2017

(Unaudited)

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 and (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.

Pharmacy Management

The Pharmacy Management segment ("Pharmacy Management") comprises products and solutions that provide clinical and financial management of pharmaceuticals paid under medical and pharmacy benefit programs. Pharmacy Management's services include: (i) pharmacy benefit management ("PBM") services; (ii) pharmacy benefit administration ("PBA") for state Medicaid and other government sponsored programs; (iii) pharmaceutical dispensing operations; (iv) clinical and formulary management programs; (v) medical pharmacy management programs; and (vi) programs for the integrated management of specialty drugs across both the medical and pharmacy benefit that treat complex conditions, regardless of site of service, method of delivery, or benefit reimbursement.

Pharmacy Management's services are provided under contracts with health plans, employers, MCOs, state Medicaid programs, Medicare Part D and other government agencies, and encompass risk based and fee for service ("FFS") arrangements. In addition, Pharmacy Management has subcontract arrangements to provide PBM services for certain Healthcare customers.

Corporate

This segment of the Company is comprised primarily of amounts not allocated to the Healthcare and Pharmacy Management segments that are largely associated with costs related to being a publicly traded company.

Summary of Significant Accounting Policies

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, "Revenue from Contracts with Customers (Topic 606)" ("ASU 2014-09"), which is a new comprehensive revenue recognition standard that will supersede virtually all existing revenue guidance under GAAP. In March 2016, the FASB issued ASU 2016-08, "Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)" ("ASU 2016-08"), which clarifies the implementation guidance on principal versus agent considerations. In April 2016, the FASB issued ASU No. 2016-10, "Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing" ("ASU 2016-10"), which clarifies the performance obligations and licensing implementation guidance of ASU 2014-09. In July 2015, the FASB deferred the effective date of ASU 2014-09. In December 2016, the FASB issued ASU No. 2016-20, "Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers" ("ASU 2016-20"), which amends various aspects of ASU 2014-09. The amendments in these ASUs are effective for annual and interim reporting periods of public entities beginning after December 15, 2017. The Company has identified its major revenue streams and is in the process of completing formal contract reviews. While the Company continues to assess all of the potential impacts of these ASUs, the Company does not expect implementation of these ASUs will have a significant impact on the Company's consolidated results of operations, financial position and cash flows. The Company continues to assess the disclosure requirements prescribed by these ASUs and it may be required to expand its disclosures. The Company intends to adopt the new standard on a modified retrospective basis.

In July 2015, the FASB issued ASU No. 2015 11, "Inventory (Topic 330): Simplifying the Measurement of Inventory" ("ASU 2015 11"). The amendment under this ASU requires that an entity measure inventory at the lower of cost or net realizable value. This guidance is effective for annual and interim reporting periods of public entities beginning after December 15, 2016 and was adopted by the Company in the quarter ended March 31, 2017. The effect of this guidance was immaterial to the Company's consolidated results of operations, financial position and cash flows.

In February 2016, the FASB issued ASU No. 2016 02, "Leases" ("ASU 2016 02"). This ASU amends the existing accounting standards for lease accounting, including requiring lessees to recognize most leases on their balance sheets. This guidance is effective for annual and interim reporting periods of public entities beginning after December 15, 2018, with early adoption permitted. The Company is currently assessing the impact of adoption, but believes the effect of this ASU will have a material effect on the Company's consolidated balance sheets. The Company is currently assessing the potential impact this ASU will have on the Company's consolidated results of operations, financial position and cash flows.

In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments" ("ASU 2016-13"). This ASU amends the accounting on reporting credit losses for assets held at amortized cost basis and available for sale debt securities. This guidance is effective for annual and interim periods of public entities beginning after December 15, 2019, with early adoption permitted for fiscal years beginning after December 31, 2018. The Company is currently assessing the potential impact this ASU will have on the Company's consolidated results of operation, financial position and cash flows.

In August 2016, the FASB issued ASU No. 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments" ("ASU 2016-15"). This ASU makes eight targeted changes to how cash receipts and cash payments are presented and classified in the statement of cash flows. This guidance is effective for annual and interim periods of public entities beginning after December 15, 2017, with early adoption permitted. The Company is currently assessing the potential impact this ASU will have on the Company's consolidated results of operation, financial positions and cash flows.

In December 2016, the FASB issued ASU 2016-19, "Technical Corrections and Improvements" ("ASU 2016-19"). The amendments in this ASU cover a wide range of Topics in the Accounting Standard Codification, including internal use software covered under Subtopic 350-40. This guidance is effective for annual and interim periods of public entities beginning after December 15, 2017, with early adoption permitted. The Company is currently assessing the potential impact this ASU will have on the Company's consolidated results of operations, financial position and cash flows.

In January 2017, the FASB issued ASU No. 2017-01, "Business Combinations (Topic 805): Clarifying the Definition of a Business" ("ASU 2017-01"). The amendments in this ASU clarify whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. This guidance is effective for annual and interim periods of public entities beginning after December 15, 2017, with early adoption permitted. The Company is currently assessing the potential impact this ASU will have on the Company's consolidated results of operations, financial position and cash flows.

In January 2017, the FASB issued ASU No. 2017-04, "Intangibles-Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment" ("ASU 2017-04"). The amendments in this ASU eliminate the requirement to calculate the implied fair value of goodwill to measure a goodwill impairment charge. This guidance is effective for annual and interim periods of public entities beginning after December 15, 2019, with early adoption permitted for interim periods after January 1, 2017. The Company is currently assessing the potential impact this ASU will have on the Company's consolidated results of operations, financial position and cash flows.

MAGELLAN HEALTH, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March, 31 2017

(Unaudited)

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, contingent consideration, 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 in which 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 $545.0 million and $559.1 million for the three months ended March 31, 2016 and 2017, respectively.

Fee For Service, Fixed Fee and Cost Plus Contracts. The Company has certain contracts with customers under which the Company recognizes revenue as services are performed and as costs are incurred. This includes revenues received in relation to the Patient Protection and Affordable Care Act health insurer fee ("HIF fee") billed on a cost reimbursement basis. The Consolidated Appropriations Act of 2016 imposed a one-year moratorium on the HIF fee, suspending its application for 2017. Revenues from these contracts approximated $103.0 million and $143.7 million for the three months ended March 31, 2016 and 2017, 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 approximated $19.8 million and $22.3 million for the three months ended March 31, 2016 and 2017, respectively.

In relation to the Company's PBM business, the Company administers rebate programs through which it receives rebates from pharmaceutical manufacturers that are shared with its customers. The Company recognizes rebates when the Company is entitled to them and when the amounts of the rebates are determinable. The amount recorded for rebates earned by the Company from the pharmaceutical manufacturers is recorded as a reduction of cost of goods sold.

PBM and Dispensing Revenue

Pharmacy Benefit Management Revenue. The Company recognizes PBM revenue, which consists of a negotiated prescription price (ingredient cost plus dispensing fee), co payments collected by the pharmacy and any associated administrative fees, when claims are adjudicated. The Company recognizes PBM revenue on a gross basis (i.e. including drug costs and co payments) as it is acting as the principal in the arrangement and is contractually obligated to its clients and network pharmacies, which is a primary indicator of gross reporting. In addition, the Company is solely responsible for the claims adjudication process, negotiating the prescription price for the pharmacy, collection of payments from the client for drugs dispensed by the pharmacy, and managing the total prescription drug

MAGELLAN HEALTH, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March, 31 2017

(Unaudited)

relationship with the client's members. If the Company enters into a contract where it is only an administrator, and does not assume any of the risks previously noted, revenue will be recognized on a net basis. PBM revenues approximated $344.5 million and $432.9 million for the three months ended March 31, 2016 and 2017, 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 $55.3 million and $55.2 million for the three months ended March 31, 2016 and 2017, respectively.

Medicare Part D. The Company is contracted with the Centers for Medicare and Medicaid ("CMS") as a Prescription Drug Plan ("PDP") to provide prescription drug benefits to Medicare beneficiaries. Net revenues include premiums earned by the PDP, which includes a direct premium paid by CMS and a beneficiary premium paid by the PDP member. In cases of low-income members, the beneficiary premium may be subsidized by CMS. The Company recognizes premium revenues on a monthly basis on a per member basis for covered members. In addition to these premiums, net revenue includes certain payments from the members based on the members' actual prescription claims, including co-payments, coverage gap benefits, deductibles and co-insurance (collectively, "Member Responsibilities"). The Company receives a prospective subsidy payment from CMS each month to subsidize a portion of the Member Responsibilities for low-income members. If the prospective subsidy differs from actual prescription claims, the difference is recorded as either a receivable or payable on the consolidated balance sheets. The Company assumes no risk for the Member Responsibilities, including the portion subsidized by CMS. The Company recognizes revenues for Member Responsibilities, including the portion subsidized by CMS, on a gross basis as claims are adjudicated. CMS also provides an annual risk corridor adjustment which compares the Company's actual drug costs incurred to the premiums received. Based on the risk corridor adjustment, the Company may receive additional premiums from CMS or may be required to refund CMS a portion of previously received premiums. The Company calculates the risk corridor adjustment on a quarterly basis and the amount is included in net revenues with a corresponding receivable or payable on the consolidated balance sheets. Medicare Part D revenues approximated $50.3 million and $111.6 million for the three months ended March 31, 2016 and 2017, respectively, including co-payments, which are included in PBM revenues above, of $9.5 million and $23.4 million for the three months ended March 31, 2016 and 2017, respectively. As of December 31, 2016 and March 31, 2017, the Company had $117.5 million and $126.7 million, respectively, in net receivables associated with Medicare Part D from CMS and other parties related to this business.

Significant Customers

Customers exceeding ten percent of the consolidated Company's net revenues

The Company has a contract with the State of Florida to provide integrated healthcare services to Medicaid enrollees in the state of Florida ("the Florida Contract"). The Florida Contract began on February 4, 2014 and extends through December 31, 2018, unless sooner terminated by the parties. The State of Florida has the right to terminate the Florida

Contract with cause, as defined, upon 24 hour notice and upon 30 days notice for any reason or no reason at all. The Florida Contract generated net revenues of $130.8 million and $145.7 million for the three months ended March 31, 2016 and 2017, respectively.

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MAGELLAN HEALTH, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March, 31 2017

(Unaudited)

Customers exceeding ten percent of segment net revenues

In addition to the Florida Contract, previously discussed, the following customers generated in excess of ten percent of net revenues for the respective segment for the three months ended March 31, 2016 and 2017 (in thousands):

Segment	Term Date	2016	2017	
Healthcare				
None				
Pharmacy Management				
Customer A	December 31, 2016 (1)	$ 99,959	$ 1,730	*
Customer B	June 30, 2019	—	92,712	

* Revenue amount did not exceed 10 percent of net revenues for the respective segment for the year presented. Amount is shown for comparative purposes only.

(1) A vast majority of this customer's revenues were generated from drug acquisition costs related to PBM services which terminated on September 1, 2016. The Company continues to provide specialty distribution services to the customer and is in negotiations with the customer to extend this contract.

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, with members under its contract with CMS and with various agencies and departments of the United States federal government. Net revenues from the Pennsylvania Counties in the aggregate totaled $110.0 million and $109.9 million for the three months ended March 31, 2016 and 2017, respectively. Net revenues from members in relation to its contract with CMS in aggregate totaled $50.3 million and $111.6 million for the three months ended March 31, 2016 and 2017, respectively. Net revenues from contracts with various agencies and departments of the United States federal government in aggregate totaled $42.5 million and $88.0 million for the three months ended March 31, 2016 and 2017, 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 has certain assets and liabilities that are required to be measured at fair value on a recurring basis. These 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

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MAGELLAN HEALTH, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March, 31 2017

(Unaudited)

observable for the asset or liability (i.e., interest rates, yield curves, 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 assets and liabilities that are required to be measured at fair value as of December 31, 2016 and March 31, 2017 (in thousands):

	December 31, 2016			
	Level 1	Level 2	Level 3	Total
Assets				
Cash and cash equivalents (1)	$ —	$ 177,495	$ —	$ 177,495
Investments:				
U.S. Government and agency securities	5,817	—	—	5,817
Obligations of government-sponsored enterprises (2)	—	25,767	—	25,767
Corporate debt securities	—	272,219	—	272,219
Certificates of deposit	—	1,450	—	1,450
Total assets held at fair value	$ 5,817	$ 476,931	$ —	$ 482,748
Liabilities				
Contingent consideration	$ —	$ —	$ 11,153	$ 11,153
Total liabilities held at fair value	$ —	$ —	$ 11,153	$ 11,153

	March 31, 2017			
	Level 1	Level 2	Level 3	Total
Assets				
Cash and cash equivalents (3)	$ —	$ 112,980	$ —	$ 112,980
Investments:				
U.S. Government and agency securities	5,704	—	—	5,704
Obligations of government-sponsored enterprises (2)	—	28,110	—	28,110
Corporate debt securities	—	273,391	—	273,391
Taxable municipal bonds	—	5,045	—	5,045
Certificates of deposit	—	1,450	—	1,450

Total assets held at fair value	$ 5,704	$ 420,976	$ —	$ 426,680
Liabilities				
Contingent consideration	$ —	$ —	$ 11,104	$ 11,104
Total liabilities held at fair value	$ —	$ —	$ 11,104	$ 11,104

(1) Excludes $127.0 million of cash held in bank accounts by the Company.
(2) Includes investments in notes issued by the Federal Home Loan Bank, Federal Farm Credit Banks and Federal National Mortgage Association.
(3) Excludes $160.6 million of cash held in bank accounts by the Company.

For the three months ended March 31, 2017, the Company has not transferred any assets between fair value measurement levels.

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The carrying values of financial instruments, including accounts receivable, accounts payable and revolving loan borrowings, approximate their fair values due to their short-term maturities. The estimated fair value of the Company’s term loans of $612.5 million as of March 31, 2017 was based on current interest rates for similar types of borrowings and is in Level 2 of the fair value hierarchy. The estimated fair values may not represent actual values of the financial instruments that could be realized as of the balance sheet date or that will be realized in the future.

All of the Company’s investments are classified as “available-for-sale” and are carried at fair value.

The contingent consideration liability reflects the fair value of potential future payments related to the Cobalt Therapeutics, LLC (“Cobalt”), The Management Group, LLC (“TMG”) and Armed Forces Services Corporation (“AFSC”) acquisitions. The Cobalt, TMG and AFSC purchase agreements provide for potential contingent payments of up to a maximum of $6.0 million, $15.0 million and $10.0 million, respectively. As of March 31, 2017, there are remaining potential future payments of $5.0 million, $15.0 million and $10.0 million for Cobalt, TMG and AFSC, respectively.

As of the balance sheet date, the fair value of contingent consideration is determined based on probabilities of payment, projected payment dates, discount rates, projected operating income, member engagement and new contract execution. The Company used a probability weighted discounted cash flow method to arrive at the fair value of the contingent consideration. As the fair value measurement for the contingent consideration is based on inputs not observed in the market, these measurements are classified as Level 3 measurements as defined by fair value measurement guidance. The unobservable inputs used in the fair value measurement include the discount rate, probabilities of payment and projected payment dates.

As of December 31, 2016 and March 31, 2017, the Company estimated undiscounted future contingent payments of $12.7 million and $12.2 million, respectively. The net decrease was mainly due to changes in operational forecasts and probabilities of payment. As of March 31, 2017, the aggregate amounts and projected dates of future potential contingent consideration payments were $10.2 million in 2017 and $2.0 million in 2020.

As of December 31, 2016, the fair value of the short-term and long-term contingent consideration was $9.4 million and $1.8 million, respectively, and is included in short-term contingent consideration and long-term contingent consideration, respectively, in the consolidated balance sheets. As of March 31, 2017, the fair value of the short-term and long-term contingent consideration was $9.8 million and $1.3 million, respectively, and is included in short-term contingent consideration and long-term contingent consideration, respectively, in the consolidated balance sheets.

The change in the fair value of the contingent consideration was $(0.3) million and $(0.1) million for the three months ended March 31, 2016 and 2017, respectively, which were recorded as direct service costs and other operating expenses in the consolidated statements of income. The decreases were mainly a result of changes in present value and the estimated undiscounted liability.

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The following table summarizes the Company's liability for contingent consideration for the three months ended March 31, 2017 (in thousands):

	March 31, 2017
Balance as of beginning of period	$ 11,153
Changes in fair value	(49)
Payments	—
Balance as of end of period	$ 11,104

Cash and Cash Equivalents

Cash equivalents are short-term, highly liquid interest-bearing investments with maturity dates of three months or less when purchased, consisting primarily of money market instruments. At March 31, 2017, the Company's excess capital and undistributed earnings for the Company's regulated subsidiaries of $121.5 million are included in cash and cash equivalents.

Investments

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 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 income and the non credit component of the other than temporary impairment is recognized in other comprehensive income.

As of December 31, 2016 and March 31, 2017, there were no unrealized losses that the Company determined to be other than temporary. No realized gains or losses were recorded for the three months ended March 31, 2016 or 2017. The following is a summary of short term and long term investments at December 31, 2016 and March 31, 2017 (in thousands):

	December 31, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Government and agency securities	$ 5,832	$ —	$ (15)	$ 5,817
Obligations of government-sponsored enterprises (1)	25,779	2	(14)	25,767

Corporate debt securities	272,479	1	(261)	272,219
Certificates of deposit	1,450	—	—	1,450
Total investments at December 31, 2016	$ 305,540	$ 3	$ (290)	$ 305,253

	March 31, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Government and agency securities	$ 5,719	$ —	$ (15)	$ 5,704
Obligations of government-sponsored enterprises (1)	28,132	—	(22)	28,110
Corporate debt securities	273,668	35	(312)	273,391
Taxable municipal bonds	5,051	—	(6)	5,045
Certificates of deposit	1,450	—	—	1,450
Total investments at March 31, 2017	$ 314,020	$ 35	$ (355)	$ 313,700

(1) Includes investments in notes issued by the Federal Home Loan Bank, Federal National Mortgage Association and Federal Farm Credit Banks.

The maturity dates of the Company's investments as of March 31, 2017 are summarized below (in thousands):

	Amortized Cost	Estimated Fair Value
2017	$ 237,361	$ 237,174
2018	76,253	76,120
2019	406	406
Total investments at March 31, 2017	$ 314,020	$ 313,700

Income Taxes

The Company's effective income tax rates were 47.3 percent and 40.3 percent for the three months ended March 31, 2016 and 2017, respectively. These rates differ from the federal statutory income tax rate primarily due to state income taxes, permanent differences between book and tax income, and changes to recorded tax contingencies and valuation allowances. The Company also accrues interest and penalties related to uncertain tax positions in its provision for income taxes. The effective income tax rate for the three months ended March 31, 2017 is lower than the effective rate for the three months ended March 31, 2016 mainly due to the suspension for 2017 of the non-deductible HIF Fees.

The Company files a consolidated federal income tax return with most of its eighty-percent or more controlled subsidiaries. The Company files a separate consolidated federal income tax return for AlphaCare of New York, Inc.

(“AlphaCare”) and its parent, AlphaCare Holdings, Inc. The Company and its subsidiaries also file income tax returns in various state and local jurisdictions. The Company is no longer subject to federal, state or local income tax assessments for years ended prior to 2013.

Net Operating Loss Carryforwards

The Company has $1.8 million of federal net operating loss carryforwards (“NOLs”) available to reduce its federal consolidated taxable income in 2017 and subsequent years. These NOLs will expire in 2018 and 2019 if not used and are subject to examination and adjustment by the Internal Revenue Service (“IRS”). AlphaCare has $41.0 million of federal NOLs available to reduce its consolidated taxable income in 2017 and subsequent years. These NOLs will expire in 2033 through 2036 if not used and are subject to examination and adjustment by the IRS. The Company and its subsidiaries also have $103.6 million of state NOLs available to reduce state taxable income at certain subsidiaries in 2017 and subsequent years. Most of these state NOLs will expire in 2017 through 2035 if not used and are subject to examination and adjustment by the respective state tax authorities.

Deferred tax assets as of December 31, 2016 and March 31, 2017 are shown net of valuation allowances of $17.1 million and $17.7 million, respectively. These valuation allowances mostly relate to uncertainties regarding the eventual realization of the AlphaCare federal NOLs and certain state NOLs. Determination of the amount of deferred tax assets considered realizable requires significant judgment and estimation regarding the forecasts of future taxable

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income which are consistent with the plans and estimates the Company uses to manage the underlying businesses. Although consideration is also given to potential tax planning strategies which might be available to improve the realization of deferred tax assets, none were identified which were both prudent and reasonable. Future changes in the estimated realizable portion of deferred tax assets could materially affect the Company's financial condition and results of operations.

Health Care Reform

The Patient Protection and the Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010 (collectively, the "Health Reform Law"), imposes a mandatory annual fee on health insurers for each calendar year beginning on or after January 1, 2014. The Company has obtained rate adjustments from customers which the Company expects will cover the direct costs of these fees and the impact from non deductibility of such fees for federal and state income tax purposes. To the extent the Company has such a customer that does not renew, there may be some impact due to taxes paid where the timing and amount of recoupment of these additional costs is uncertain. In the event the Company is unable to obtain rate adjustments to cover the financial impact of the annual fee, the fee may have a material impact on the Company. The Consolidated Appropriations Act of 2016 imposed a one-year moratorium on the HIF fee, suspending its application for 2017. The HIF fee is scheduled to go back into effect for 2018. For 2016 the HIF fees were $26.5 million which has been paid. Of this amount, $7.1 million was expensed in the three months ended March 31, 2016, which was included in direct service costs and other operating expenses in the consolidated statements of income. The Company recorded revenues of $11.3 million in the three months ended March 31, 2016, associated with the accrual for the reimbursement of the economic impact of the HIF fees from its customers. As of March 31, 2017, the Company has a $13.3 million receivable related to a terminated contract that the customer has expressed their unwillingness to pay, however the Company believes the amount is collectible and has not established a reserve.

Stock Compensation

At December 31, 2016 and March 31, 2017, the Company had equity based employee incentive plans, which are described more fully in Note 6 in the Company's Annual Report on Form 10 K for the year ended December 31, 2016, which was filed with the SEC on February 24, 2017. The Company recorded stock compensation expense of $8.9 million and $10.1 million for the three months ended March 31, 2016 and 2017, respectively. Stock compensation expense recognized in the consolidated statements of income for the three months ended March 31, 2016 and 2017 has been reduced for forfeitures, estimated at between zero and four percent for both periods.

The weighted average grant date fair value of all stock options granted during the three months ended March 31, 2017 was $17.10 as estimated using the Black Scholes Merton option pricing model, which also assumed an expected volatility of 27.8 percent based on the historical volatility of the Company's stock price.

For the three months ended March 31, 2016, the benefit of tax deductions in excess of recognized stock compensation expense (net of deficiencies) was $0.3 million, which was reported as a change to additional paid in capital. For the three months ended March 31, 2017, the benefit of tax deductions in excess of recognized stock compensation expense (net of deficiencies) was $0.9 million. Due to the adoption of ASU 2016-09 in the 4th quarter of 2016, this net benefit is reported as a reduction to income tax expense rather than as a change in additional paid-in-capital. Consistent with the adoption of this standard, the net tax benefit is reflected as an operating cash flow rather than a financing cash flow.