

HealthSpring, Inc.
Form 10-Q
July 30, 2010

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended June 30, 2010
Commission File Number: 001-32739
HealthSpring, Inc.
(Exact Name of Registrant as Specified in Its Charter)**

Delaware **20-1821898**
(State or Other Jurisdiction of Incorporation or (I.R.S. Employer Identification No.)
Organization)

9009 Carothers Parkway
Suite 501
Franklin, Tennessee **37067**
(Address of Principal Executive Offices) (Zip Code)
(615) 291-7000
(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 12 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 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 or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated Filer Accelerated Filer Non-accelerated Filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Outstanding at July 28, 2010

Common Stock, Par Value \$0.01 Per Share

57,208,381 Shares

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HEALTHSPRING, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)
(unaudited)

| Assets | June 30, 2010 | December 31, 2009 |
|--|------------------|----------------------|
| Current assets: | | |
| Cash and cash equivalents | \$ 103,697 | \$ 439,423 |
| Accounts receivable, net | 213,671 | 92,442 |
| Investment securities available for sale | | 8,883 |
| Investment securities held to maturity | | 13,965 |
| Funds due for the benefit of members | | 4,028 |
| Deferred income taxes | 5,167 | 6,973 |
| Prepaid expenses and other assets | 10,805 | 9,586 |
| Total current assets | 333,340 | 575,300 |
| Investment securities available for sale | 259,875 | 13,574 |
| Investment securities held to maturity | 42,567 | 38,463 |
| Property and equipment, net | 29,498 | 30,316 |
| Goodwill | 624,507 | 624,507 |
| Intangible assets, net | 194,822 | 203,147 |
| Restricted investments | 20,856 | 16,375 |
| Risk corridor receivable from CMS | 26,083 | |
| Other assets | 20,654 | 6,585 |
| Total assets | \$ 1,552,202 | \$ 1,508,267 |

Liabilities and Stockholders Equity

| | | |
|--|-------------|-------------|
| Current liabilities: | | |
| Medical claims liability | \$ 216,530 | \$ 202,308 |
| Accounts payable, accrued expenses and other | 44,396 | 50,954 |
| Risk corridor payable to CMS | 2,720 | 2,176 |
| Funds held for the benefit of members | 24,504 | |
| Current portion of long-term debt | 17,500 | 43,069 |
| Total current liabilities | 305,650 | 298,507 |
| Long-term debt, less current portion | 153,125 | 193,904 |
| Deferred income taxes | 75,037 | 80,434 |
| Other long-term liabilities | 5,458 | 5,966 |
| Total liabilities | 539,270 | 578,811 |

Stockholders equity:

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| | | |
|--|--------------|--------------|
| Common stock, \$.01 par value, 180,000,000 shares authorized, 61,256,707 issued and 57,202,775 outstanding at June 30, 2010, and 60,758,958 issued and 57,560,350 outstanding at December 31, 2009 | 613 | 608 |
| Additional paid-in capital | 553,731 | 548,481 |
| Retained earnings | 518,341 | 428,765 |
| Accumulated other comprehensive income (loss), net | 2,224 | (1,044) |
| Treasury stock, at cost, 4,053,932 shares at June 30, 2010, and 3,198,608 shares at December 31, 2009 | (61,977) | (47,354) |
| Total stockholders' equity | 1,012,932 | 929,456 |
| Total liabilities and stockholders' equity | \$ 1,552,202 | \$ 1,508,267 |

See accompanying notes to condensed consolidated financial statements.

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HEALTHSPRING, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except share data)
(unaudited)

| | Three Months Ended | | Six Months Ended | |
|---|---------------------------|------------------|-------------------------|------------------|
| | June 30, | | June 30, | |
| | 2010 | 2009 | 2010 | 2009 |
| Revenue: | | | | |
| Premium revenue | \$ 756,342 | \$ 671,450 | \$ 1,505,720 | \$ 1,306,046 |
| Management and other fees | 10,590 | 9,987 | 20,778 | 19,956 |
| Investment income | 1,547 | 1,106 | 2,423 | 2,656 |
| Total revenue | 768,479 | 682,543 | 1,528,921 | 1,328,658 |
| Operating expenses: | | | | |
| Medical expense | 604,933 | 558,403 | 1,217,452 | 1,088,002 |
| Selling, general and administrative | 66,216 | 62,306 | 142,746 | 134,557 |
| Depreciation and amortization | 7,510 | 7,642 | 15,297 | 15,166 |
| Interest expense | 2,254 | 3,970 | 12,225 | 8,251 |
| Total operating expenses | 680,913 | 632,321 | 1,387,720 | 1,245,976 |
| Income before income taxes | 87,566 | 50,222 | 141,201 | 82,682 |
| Income tax expense | (31,791) | (18,331) | (51,625) | (30,179) |
| Net income | \$ 55,775 | \$ 31,891 | \$ 89,576 | \$ 52,503 |
| Net income per common share: | | | | |
| Basic | \$ 0.98 | \$ 0.59 | \$ 1.57 | \$ 0.96 |
| Diluted | \$ 0.98 | \$ 0.58 | \$ 1.56 | \$ 0.96 |
| Weighted average common shares outstanding: | | | | |
| Basic | 56,917,219 | 54,497,780 | 57,069,994 | 54,490,155 |
| Diluted | 57,049,980 | 54,770,212 | 57,302,567 | 54,794,251 |

See accompanying notes to condensed consolidated financial statements.

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HEALTHSPRING, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

| | Six Months Ended | |
|---|-------------------------|-------------|
| | June 30, | |
| | 2010 | 2009 |
| Cash flows from operating activities: | | |
| Net income | \$ 89,576 | \$ 52,503 |
| Adjustments to reconcile net income to net cash used in operating activities: | | |
| Depreciation and amortization | 15,297 | 15,166 |
| Share-based compensation | 4,777 | 5,158 |
| Amortization of deferred financing cost | 958 | 1,203 |
| Amortization on bond investments | 1,088 | 485 |
| Equity in earnings of unconsolidated affiliate | (228) | (103) |
| Deferred tax benefit | (5,501) | (6,585) |
| Write-off of deferred financing fees | 5,079 | |
| Increase (decrease) in cash due to: | | |
| Accounts receivable | (121,229) | (75,159) |
| Prepaid expenses and other assets | (13,850) | (2,734) |
| Medical claims liability | 14,222 | 31,315 |
| Accounts payable, accrued expenses, and other current liabilities | (7,042) | (9,246) |
| Risk corridor payable to/receivable from CMS | (25,539) | (20,602) |
| Other | 1,598 | 654 |
| Net cash used in operating activities | (40,794) | (7,945) |
| Cash flows from investing activities: | | |
| Additional consideration paid on acquisition | (610) | (910) |
| Purchases of property and equipment | (5,544) | (5,502) |
| Purchases of investment securities | (327,257) | (28,687) |
| Maturities of investment securities | 50,075 | 22,737 |
| Sales of investment securities | 51,666 | |
| Purchases of restricted investments | (32,522) | (10,123) |
| Maturities of restricted investments | 28,025 | 6,344 |
| Distributions received from unconsolidated affiliate | 87 | |
| Net cash used in investing activities | (236,080) | (16,141) |
| Cash flows from financing activities: | | |
| Funds received for the benefit of the members | 416,917 | 325,004 |
| Funds withdrawn for the benefit of members | (388,385) | (271,476) |
| Proceeds received on issuance of debt | 200,000 | |
| Payments on long-term debt | (266,347) | (16,678) |
| Excess tax benefit from stock options exercised | 124 | |
| Proceeds from stock options exercised | 477 | 6 |

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| | | |
|---|------------|------------|
| Purchase of treasury stock | (14,304) | |
| Payment of debt issue costs | (7,334) | |
| Net cash (used in) provided by financing activities | (58,852) | 36,856 |
| Net (decrease) increase in cash and cash equivalents | (335,726) | 12,770 |
| Cash and cash equivalents at beginning of period | 439,423 | 282,240 |
| Cash and cash equivalents at end of period | \$ 103,697 | \$ 295,010 |
| Supplemental disclosures: | | |
| Cash paid for interest | \$ 6,050 | \$ 7,329 |
| Cash paid for taxes | \$ 55,628 | \$ 37,749 |
| See accompanying notes to condensed consolidated financial statements | | |

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HEALTHSPRING, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

(1) Organization and Basis of Presentation

HealthSpring, Inc., a Delaware corporation (the Company), was organized in October 2004 and began operations in March 2005 in connection with a recapitalization transaction accounted for as a purchase. The Company is a managed care organization whose primary focus is on Medicare, the federal government sponsored health insurance program for United States citizens aged 65 and older, qualifying disabled persons, and persons suffering from end-stage renal disease. Through its health maintenance organization (HMO) and regulated insurance subsidiaries, the Company operates Medicare Advantage health plans in the states of Alabama, Florida, Georgia, Illinois, Mississippi, Tennessee, and Texas and offers Medicare Part D prescription drug plans on a national basis. The Company also provides management services to physician practices.

The accompanying condensed consolidated financial statements are unaudited and should be read in conjunction with the consolidated financial statements and notes thereto of HealthSpring, Inc. as of and for the year ended December 31, 2009, included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009 as filed with the Securities and Exchange Commission (the SEC) on February 11, 2010 (the 2009 Form 10-K). The accompanying unaudited condensed consolidated financial statements reflect the Company's financial position as of June 30, 2010, the Company's results of operations for the three and six months ended June 30, 2010 and 2009, and cash flows for the six months ended June 30, 2010 and 2009. Certain 2009 amounts have been reclassified to conform to the 2010 presentation.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities Exchange Act of 1934, as amended (the Exchange Act). Accordingly, certain information and footnote disclosures normally included in complete financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to the rules and regulations applicable to interim financial statements. In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all adjustments (including normally recurring accruals) necessary to present fairly the Company's financial position at June 30, 2010, its results of operations for the three and six months ended June 30, 2010 and 2009, and its cash flows for the six months ended June 30, 2010 and 2009.

The results of operations for the 2010 interim periods are not necessarily indicative of the operating results that may be expected for the full year ending December 31, 2010.

The preparation of the condensed consolidated financial statements requires management of the Company to make a number of estimates and assumptions relating to the reported amount of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the period. The most significant item subject to estimates and assumptions is the actuarial calculation for obligations related to medical claims. Other significant items subject to estimates and assumptions include the Company's estimated risk adjustment payments receivable from the Centers for Medicare & Medicaid Services (CMS), the valuation of goodwill and intangible assets, the useful life of definite-lived intangible assets, the valuation of debt securities carried at fair value, and certain amounts recorded related to the Company's Part D operations. Actual results could differ significantly from those estimates and assumptions.

The Company's regulated insurance subsidiaries are restricted from making distributions without appropriate regulatory notifications and approvals or to the extent such distributions would cause non-compliance with statutory capital requirements. At June 30, 2010, \$370.7 million of the Company's \$427.0 million of cash, cash equivalents, investment securities, and restricted investments were held by the Company's insurance subsidiaries and subject to these dividend restrictions.

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(unaudited)

(2) Recently Adopted Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued new guidance for determining whether an entity is a variable interest entity (VIE) and requires an enterprise to perform an analysis to determine whether the enterprise's variable interest or interests give it a controlling financial interest in a VIE. The guidance requires an enterprise to assess whether it has an implicit financial responsibility to ensure that a VIE operates as designed when determining whether it has power to direct the activities of the VIE that most significantly impact the entity's economic performance. The guidance also requires ongoing assessments of whether an enterprise is the primary beneficiary of a VIE, requires enhanced disclosures, and eliminates the scope exclusion for qualifying special-purpose entities. The adoption of the new guidance on January 1, 2010 did not impact our financial statements.

Effective January 1, 2010, the Company adopted the FASB's updated guidance related to fair value measurements and disclosures, which requires a reporting entity to disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and to describe the reasons for the transfers. In addition, in the reconciliation for fair value measurements using significant unobservable inputs, or Level 3, a reporting entity should disclose separately information about purchases, sales, issuances and settlements. The updated guidance also requires that an entity should provide fair value measurement disclosures for each class of assets and liabilities and disclosures about the valuation techniques and inputs used to measure fair value for both recurring and non-recurring fair value measurements for Level 2 and Level 3 fair value measurements. The guidance is effective for interim or annual financial reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances and settlements in the roll forward activity in Level 3 fair value measurements, which are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. Therefore, the Company has not yet adopted the guidance with respect to the roll forward activity in Level 3 fair value measurements. The adoption of the updated guidance for Levels 1 and 2 fair value measurements did not have an impact on the Company's consolidated results of operations or financial condition.

(3) Accounts Receivable

Accounts receivable at June 30, 2010 and December 31, 2009 consisted of the following (in thousands):

| | June 30, 2010 | December 31, 2009 |
|---|--------------------------|------------------------------|
| Medicare premium receivables | \$ 130,302 | \$ 48,524 |
| Rebates | 74,887 | 34,879 |
| Due from providers | 19,630 | 10,320 |
| Other | 3,509 | 2,400 |
| | 228,328 | 96,123 |
| Allowance for doubtful accounts | (2,166) | (3,681) |
| Total (including portions classified as current and non-current assets) | \$ 226,162 | \$ 92,442 |

Medicare premium receivables at June 30, 2010 and December 31, 2009 consists primarily of receivables from CMS related to the accrual of retroactive risk adjustment payments. The Company will receive retroactive risk payments from CMS of \$119.7 million in the 2010 third quarter. Accounts receivable relating to unpaid health plan enrollee premiums are recorded during the period the Company is obligated to provide services to enrollees and do not bear interest. The Company does not have any off-balance sheet credit exposure related to its health plan enrollees. Rebates for drug costs represent estimated rebates owed to the Company from prescription drug companies. The Company has entered into contracts with certain drug manufacturers that provide for rebates to the Company based on the utilization of specific prescription drugs by the Company's members. Due from providers primarily includes

management fees receivable as well as amounts owed to the Company for the refund of certain medical expenses paid by the Company under risk sharing agreements.

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HEALTHSPRING, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

(4) Investment Securities

Investment securities, which consist primarily of debt securities, have been categorized as either available for sale or held to maturity. Held to maturity securities are those securities that the Company does not intend to sell, nor expect to be required to sell, prior to maturity. The Company holds no trading securities. At June 30, 2010, investment securities are classified as non-current assets based on the Company's intention to reinvest such assets upon sale or maturity and to not use such assets in current operations. At December 31, 2009, the Company classified its investment securities based upon maturity dates. Restricted investments include U.S. Government securities, money market fund investments, deposits and certificates of deposit held by the various state departments of insurance to whose jurisdiction the Company's subsidiaries are subject. These restricted assets are recorded at amortized cost and classified as long-term regardless of the contractual maturity date because of the restrictive nature of the states requirements.

Available for sale securities are recorded at fair value. Held to maturity debt securities are recorded at amortized cost, adjusted for the amortization or accretion of premiums or discounts. Unrealized gains and losses (net of applicable deferred taxes) on available for sale securities are included as a component of stockholders' equity and comprehensive income until realized from a sale or other than temporary impairment. Realized gains and losses from the sale of securities are determined on a specific identification basis. Purchases and sales of investments are recorded on their trade dates. Dividend and interest income are recognized when earned.

There were no available for sale securities classified as current assets as of June 30, 2010. Available for sale securities classified as current assets at December 31, 2009 were as follows (in thousands):

| | Amortized Cost | December 31, 2009 Gross Unrealized Holding Gains | Gross Unrealized Holding Losses | Estimated Fair Value |
|-----------------|---------------------------|---|--|---------------------------------|
| Municipal bonds | \$ 8,691 | 192 | | 8,883 |

Available for sale securities classified as non-current assets were as follows (in thousands):

| | June 30, 2010 Gross Unrealized | Gross Unrealized | Estimated Fair Value | December 31, 2009 Gross Unrealized | Gross Unrealized | Estimated Fair Value |
|--|---|-----------------------------|-------------------------------------|---|-----------------------------|-------------------------------------|
| | Amortized Cost | Holding Gains | Holding Losses | Amortized Cost | Holding Gains | Holding Losses |
| Government obligations | \$ 10,453 | 110 | | \$ 10,563 | | |
| Agency obligations | 2,966 | 37 | | 3,003 | | |
| Corporate debt securities | 86,565 | 1,175 | (97) | 87,643 | | |
| Mortgage-backed securities (Residential) | 66,491 | 1,445 | (1) | 67,935 | | |
| Other structured securities | 12,461 | 219 | | 12,680 | | |

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| | | | | | | | | |
|-----------------|------------|-------|-------|---------|-----------|-----|-----|--------|
| Municipal bonds | 77,467 | 613 | (29) | 78,051 | 13,407 | 176 | (9) | 13,574 |
| | \$ 256,403 | 3,599 | (127) | 259,875 | \$ 13,407 | 176 | (9) | 13,574 |

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HEALTHSPRING, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

There were no held to maturity securities classified as current assets at June 30, 2010. Held to maturity securities classified as current assets at December 31, 2009 were as follows (in thousands):

| | Amortized Cost | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses | Estimated Fair Value |
|---------------------------|-------------------|---|--|-------------------------|
| Government obligations | \$ 1,154 | 1 | | 1,155 |
| Agency obligations | 3,225 | 16 | | 3,241 |
| Corporate debt securities | 6,416 | 74 | | 6,490 |
| Municipal bonds | 3,170 | 20 | | 3,190 |
| | \$ 13,965 | 111 | | 14,076 |

Held to maturity securities classified as non-current assets were as follows (in thousands):

| | June 30, 2010 | | | Estimated Fair Value | December 31, 2009 | | | Estimated Fair Value |
|--|-------------------|---|--|----------------------------|-------------------|---|--|----------------------------|
| | Amortized Cost | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses | | Amortized Cost | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses | |
| Government obligations | \$ 1,417 | 7 | | 1,424 | \$ | | | 1,424 |
| Agency obligations | 3,160 | 39 | | 3,199 | 1,610 | 12 | | 1,622 |
| Corporate debt securities | 14,875 | 311 | (5) | 15,181 | 13,505 | 325 | | 13,830 |
| Mortgage-backed securities (Residential) | | | | | 1,575 | 6 | | 1,581 |
| Municipal bonds | 23,115 | 751 | | 23,866 | 21,773 | 546 | (1) | 22,318 |
| | \$ 42,567 | 1,108 | (5) | 43,670 | \$ 38,463 | 889 | (1) | 39,351 |

Realized gains or losses related to investment securities for the three and six months ended June 30, 2010 and 2009 were immaterial.

Maturities of investments were as follows at June 30, 2010 (in thousands):

| | Available for sale | | Held to maturity | |
|--|--------------------|-------------------------|-------------------|-------------------------|
| | Amortized Cost | Estimated Fair Value | Amortized Cost | Estimated Fair Value |
| Due within one year | \$ 12,494 | 12,572 | \$ 11,299 | 11,440 |
| Due after one year through five years | 129,203 | 130,580 | 29,205 | 30,032 |
| Due after five years through ten years | 26,535 | 26,867 | 2,063 | 2,198 |
| Due after ten years | 9,220 | 9,242 | | |

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| | | | | |
|--------------------------------------|------------|---------|-----------|--------|
| Mortgage and asset-backed securities | 78,951 | 80,614 | | |
| | \$ 256,403 | 259,875 | \$ 42,567 | 43,670 |

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HEALTHSPRING, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Gross unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at June 30, 2010, were as follows (in thousands):

| | Less Than 12 Months | | More Than 12 Months | | Total | |
|---|--------------------------------|-----------------------|--------------------------------|-----------------------|------------------------------|-----------------------|
| | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value |
| Corporate debt securities | \$ (102) | 10,285 | | | (102) | 10,285 |
| Mortgage-backed securities (Residential) | (1) | 1,042 | | | (1) | 1,042 |
| Municipal securities | (29) | 8,223 | | | (29) | 8,223 |
| | \$ (132) | 19,550 | | | (132) | 19,550 |

Gross unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2009, were as follows (in thousands):

| | Less Than 12 Months | | More Than 12 Months | | Total | |
|-----------------|--------------------------------|-----------------------|--------------------------------|-----------------------|------------------------------|-----------------------|
| | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value |
| Municipal bonds | \$ (10) | 1,920 | | | (10) | 1,920 |

The Company reviews fixed maturities and equity securities with a decline in fair value from cost for impairment based on criteria that include duration and severity of decline; financial viability and outlook of the issuer; and changes in the regulatory, economic and market environment of the issuer's industry or geographic region. All issuers of securities the Company owned in an unrealized loss as of June 30, 2010 remain current on all contractual payments. The unrealized losses on investments were caused by an increase in investment yields as a result of a widening of credit spreads. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. The Company determined that it did not intend to sell these investments and that it was not more-likely-than-not to be required to sell these investments prior to their recovery, thus these investments are not considered other-than-temporarily impaired.

(5) Fair Value Measurements

The Company's 2010 second quarter condensed consolidated balance sheet includes the following financial instruments: cash and cash equivalents, accounts receivable, investment securities, restricted investments, accounts payable, medical claims liabilities, funds due (held) from CMS for the benefit of members, and long-term debt. The carrying amounts of accounts receivable, funds due (held) from CMS for the benefit of members, accounts payable, and medical claims liabilities approximate their fair value because of the relatively short period of time between the origination of these instruments and their expected realization. The fair value of the Company's long-term debt (including the current portion) was \$167.2 million at June 30, 2010 and consisted solely of non-tradable bank debt.

Cash and cash equivalents consist of such items as certificates of deposit, commercial paper, and money market funds. The original cost of these assets approximates fair value due to their short-term maturity. In February 2010, the Company terminated its interest rate swap agreements in connection with the termination of the related credit agreement. See Note 12 Debt . The fair value of the Company's interest rate swaps at December 31, 2009 reflected a liability of approximately \$2.1 million and was included in other long term liabilities in the accompanying condensed consolidated balance sheet. The fair values of available for sale securities is determined by quoted market prices or pricing models developed using market data provided by a third party vendor.

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HEALTHSPRING, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

The following are the levels of the hierarchy as and a brief description of the type of valuation information (inputs) that qualifies a financial asset for each level:

| Level Input | Input Definition |
|--------------------|--|
| Level I | Inputs are unadjusted quoted prices for identical assets or liabilities in active markets at the measurement date. |
| Level II | Inputs other than quoted prices included in Level I that are observable for the asset or liability through corroboration with market data at the measurement date. |
| Level III | Unobservable inputs that reflect management s best estimate of what market participants would use in pricing the asset or liability at the measurement date. |

When quoted prices in active markets for identical assets are available, the Company uses these quoted market prices to determine the fair value of financial assets and classifies these assets as Level I. In other cases where a quoted market price for identical assets in an active market is either not available or not observable, the Company obtains the fair value from a third party vendor that uses pricing models, such as matrix pricing, to determine fair value. These financial assets would then be classified as Level II. In the event quoted market prices were not available, the Company would determine fair value using broker quotes or an internal analysis of each investment s financial statements and cash flow projections. In these instances, financial assets would be classified based upon the lowest level of input that is significant to the valuation. Thus, financial assets might be classified in Level III even though there could be some significant inputs that may be readily available.

There were no transfers to or from Levels I and II during the six months ended June 30, 2010. The following tables summarize fair value measurements by level at June 30, 2010 and December 31, 2009 for assets and liabilities measured at fair value on a recurring basis (in thousands):

| | June 30, 2010 | | | Total |
|---|----------------------|-----------------|------------------|--------------|
| | Level I | Level II | Level III | |
| Assets | | | | |
| Cash and cash equivalents | \$ 103,697 | \$ | \$ | \$ 103,697 |
| Investments: available for sale securities: | | | | |
| Government obligations | \$ 8,424 | \$ 2,139 | \$ | \$ 10,563 |
| Agency obligations | | 3,003 | | 3,003 |
| Corporate debt securities | | 87,643 | | 87,643 |
| Mortgage-backed securities (Residential) | | 67,935 | | 67,935 |
| Other structured securities | | 12,680 | | 12,680 |
| Municipal securities | | 78,051 | | 78,051 |
| | \$ 8,424 | \$ 251,451 | \$ | \$ 259,875 |

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| | December 31, 2009 | | | Total |
|---|--------------------------|-----------------|------------------|--------------|
| | Level I | Level II | Level III | |
| Assets | | | | |
| Cash and cash equivalents | \$ 439,423 | \$ | \$ | \$ 439,423 |
| Investments: available for sale securities: | | | | |
| Municipal securities | \$ | 22,457 | | 22,457 |
| Liabilities | | | | |
| Derivative interest rate swaps | \$ | \$ 2,066 | \$ | \$ 2,066 |

(6) Medical Liabilities

The Company's medical liabilities at June 30, 2010 and December 31, 2009 consisted of the following (in thousands):

| | June 30, 2010 | December 31, 2009 |
|------------------------------|--------------------------|------------------------------|
| Medicare medical liabilities | \$ 172,911 | \$ 156,660 |
| Pharmacy liabilities | 43,619 | 45,648 |
| | \$ 216,530 | \$ 202,308 |

(7) Medicare Part D

Total Part D related net assets (excluding medical claims payable) of \$1.9 million at December 31, 2009 all relate to the 2009 CMS plan year. The Company's Part D related assets and liabilities (excluding medical claims payable) at June 30, 2010 were as follows (in thousands):

| | Related to the 2009 plan year | Related to the 2010 plan year | Total |
|---|--|--|--------------|
| Current assets (liabilities): | | | |
| Funds due (held) for the benefit of members | \$ 4,135 | \$ (28,639) | \$ (24,504) |
| Risk corridor payable to CMS | \$ (2,720) | \$ | \$ (2,720) |
| Non-current assets: | | | |
| Risk corridor receivable from CMS | \$ | \$ 26,083 | \$ 26,083 |

Balances associated with risk corridor amounts are expected to be settled in the second half of the year following the year to which they relate. Current year Part D amounts are routinely updated in subsequent periods as a result of retroactivity.

(8) Derivatives

In October 2008, the Company entered into two interest rate swap agreements in a total notional amount of \$100.0 million, relating to the floating interest rate component of the term loan agreement under its previous credit facility (collectively, the 2007 Credit Agreement). In February 2010, the Company terminated its interest rate swap

agreements in connection with the termination of the 2007 Credit Agreement. See Note 12 Debt . The interest rate swap agreements were classified as cash flow hedges. See Note 5 Fair Value Measurements . All derivatives were recognized on the balance sheet at their fair value. To the extent that the cash flow hedges are effective, changes in their fair value were recorded in other comprehensive income (loss) until earnings are affected by the variability of cash flows of the hedged transaction (e.g. until periodic settlements of a variable asset or liability are recorded in earnings). Any hedge ineffectiveness (which represents the amount by which the changes in the fair value of the derivatives differ from changes in the fair value of the hedged instrument) was recorded in current-period earnings. As a result of terminating the interest rate swap agreements, the Company settled the swap obligations with the counterparties for approximately \$2.0 million and reclassified such amount from other comprehensive income to interest expense during the first quarter of 2010.

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The Company had no derivative financial instruments outstanding at June 30, 2010. A summary of the aggregate notional amounts, balance sheet location and estimated fair values of derivative financial instruments at December 31, 2009 was as follows (in thousands):

| Hedging instruments | Notional Amount | Balance Sheet Location | Estimated Fair Value Asset | (Liability) |
|----------------------------|------------------------|-------------------------------|-----------------------------------|--------------------|
| Interest rate swaps | \$ 100,000 | Other noncurrent liabilities | | (2,066) |

A summary of the effect of cash flow hedges on the Company's financial statements for the periods presented is as follows (in thousands):

| Type of Cash Flow Hedge | Pretax Hedge Gain (Loss) Recognized in | Effective Portion | | Other Comprehensive Income | Other Comprehensive Income | Other Comprehensive Income | Location of Gain (Loss) Recognized | Hedge Gain (Loss) Recognized |
|---|---|--------------------------|--------------------------|-----------------------------------|-----------------------------------|-----------------------------------|---|-------------------------------------|
| | | Income Statement | Hedge Gain (Loss) | | | | | |
| For the three months ended June 30, 2010: | | | | | | | | |
| Interest rate swaps | \$ | Interest Expense | \$ | None | \$ | | | |
| For the three months ended June 30, 2009: | | | | | | | | |
| Interest rate swaps | \$ 374 | Interest Expense | \$ | None | \$ | | | |
| For the six months ended June 30, 2010: | | | | | | | | |
| Interest rate swaps | \$ 38 | Interest Expense | \$ (1,253) | None | \$ | | | |
| For the six months ended June 30, 2009: | | | | | | | | |
| Interest rate swaps | \$ 588 | Interest Expense | \$ | None | \$ | | | |

(9) Intangible Assets

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A breakdown of the identifiable intangible assets and their assigned value and accumulated amortization at June 30, 2010 is as follows (in thousands):

| | Gross Carrying Amount | Accumulated Amortization | Net |
|---------------------------|--------------------------------------|-------------------------------------|------------|
| Trade name | \$ 24,497 | \$ | \$ 24,497 |
| Noncompete agreements | 800 | 800 | |
| Provider network | 137,679 | 26,875 | 110,804 |
| Medicare member network | 93,620 | 35,136 | 58,484 |
| Management contract right | 1,555 | 518 | 1,037 |
| | \$ 258,151 | \$ 63,329 | \$ 194,822 |

Amortization expense on identifiable intangible assets for the three months ended June 30, 2010 and 2009 was approximately \$4.5 million and \$4.6 million, respectively. Amortization expense on identifiable intangible assets for the six months ended June 30, 2010 and 2009 was approximately \$8.9 million and \$9.2 million, respectively.

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(10) Share-Based Compensation

Stock Options

The Company granted options to purchase 535,712 shares of common stock pursuant to the 2006 Equity Incentive Plan during the six months ended June 30, 2010. Options for the purchase of 351,487 shares of common stock either were forfeited or expired during the six months ended June 30, 2010. Options for the purchase of 4,049,202 shares of common stock were outstanding under this plan at June 30, 2010. The outstanding options vest and become exercisable based on time, generally over a four-year period, and expire ten years from their grant dates.

Restricted Stock

During the six months ended June 30, 2010, the Company granted 415,945 shares of restricted stock to employees pursuant to the 2006 Equity Incentive Plan, the restrictions of which generally lapse over a four-year period. Additionally, 35,043 shares were purchased by certain executives pursuant to the Management Stock Purchase Plan (the MSPP). The restrictions on shares purchased under the MSPP generally lapse on the second anniversary of the grant date. Unvested restricted stock at June 30, 2010 totaled 726,975 shares.

During the six months ended June 30, 2010, the Company awarded 29,035 shares of restricted stock to certain of its directors pursuant to the 2006 Equity Incentive Plan, all of which were outstanding at June 30, 2010. The restrictions relating to the restricted stock awarded to non-employee directors in 2010 generally lapse one year from the grant date. In the event a director resigns or is removed prior to the lapsing of the restriction, or if the director fails to attend 75% of the board and applicable committee meetings during the one-year period, shares will be forfeited unless resignation or failure to attend is caused by death or disability.

In May 2010, the Company's stockholders approved an amendment and restatement of the 2006 Equity Incentive Plan. Among other items, the amendments increased the number of shares available for issuance under the plan by 3,250,000 shares, 1,750,000 of which are available for restricted share awards.

Stock Repurchase Program

In May 2010, the Company's Board of Directors authorized a stock repurchase program to buy back up to \$100.0 million of the Company's common stock through June 30, 2011. The program authorizes purchases of common stock from time to time in either the open market or through private transactions, in accordance with SEC and other applicable legal requirements. The timing, prices, and sizes of purchases depends upon prevailing stock prices, general economic and market conditions, and other considerations. Funds for the repurchase of shares have, and are expected to, come primarily from unrestricted cash on hand and unrestricted cash generated from operations. The repurchase program does not obligate the Company to acquire any particular amount of common stock and the repurchase program may be suspended at any time at the Company's discretion. As of June 30, 2010, the Company had repurchased 837,634 shares of its common stock under the program in open market transactions for approximately \$14.3 million, at an average cost of \$17.10 per share, and had approximately \$85.7 million in remaining repurchase authority under the program.

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(11) Net Income Per Common Share

The following table presents the calculation of the Company's net income per common share—basic and diluted (in thousands, except share data):

| | Three Months Ended | | Six Months Ended | |
|--|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2010 | 2009 | 2010 | 2009 |
| Numerator: | | | | |
| Net income | \$ 55,775 | \$ 31,891 | \$ 89,576 | \$ 52,503 |
| Denominator: | | | | |
| Weighted average common shares outstanding—basic | 56,917,219 | 54,497,780 | 57,069,994 | 54,490,155 |
| Dilutive effect of stock options | 44,949 | 71,278 | 88,500 | 74,652 |
| Dilutive effect of unvested restricted shares | 87,812 | 201,154 | 144,073 | 229,444 |
| Weighted average common shares outstanding—diluted | 57,049,980 | 54,770,212 | 57,302,567 | 54,794,251 |
| Net income per common share: | | | | |
| Basic | \$ 0.98 | \$ 0.59 | \$ 1.57 | \$ 0.96 |
| Diluted | \$ 0.98 | \$ 0.58 | \$ 1.56 | \$ 0.96 |

Diluted earnings per share (EPS) reflects the potential dilution that could occur from outstanding equity plan awards, including unexercised stock options and unvested restricted shares. The dilutive effect is computed using the treasury stock method, which assumes all share-based awards are exercised and the hypothetical proceeds from exercise are used by the Company to purchase common stock at the average market price during the period. The incremental shares (difference between shares assumed to be issued versus purchased), to the extent they would have been dilutive, are included in the denominator of the diluted EPS calculation. Options with respect to 4.2 million shares and 4.1 million shares were antidilutive and therefore excluded from the computation of diluted earnings per share for the three months ended June 30, 2010 and 2009, respectively. Options with respect to 4.1 million shares were antidilutive and therefore excluded from the computation of diluted earnings per share for the six months ended June 30, 2010 and 2009.

(12) Debt

Long-term debt at June 30, 2010 and December 31, 2009 consisted of the following (in thousands):

| | June 30, | December 31, |
|---|-----------------|---------------------|
| | 2010 | 2009 |
| Credit agreement | \$ 170,625 | \$ 236,973 |
| Less: current portion of long-term debt | (17,500) | (43,069) |
| Long-term debt less current portion | \$ 153,125 | \$ 193,904 |

On February 11, 2010, the Company entered into a \$350.0 million credit agreement (the *New Credit Agreement*), which, subject to the terms and conditions set forth therein, provides for a five-year \$175.0 million term loan credit facility and a four-year \$175.0 million revolving credit facility (the *New Credit Facilities*). Proceeds from the New

Credit Facilities, together with cash on hand, were used to fund the repayment of \$237.0 million in term loans outstanding under the Company's 2007 credit agreement as well as transaction expenses related thereto. Borrowings under the New Credit Agreement accrue interest on the basis of either a base rate or a LIBOR rate plus, in each case, an applicable margin depending on the Company's debt-to-EBITDA leverage ratio (275 basis points for LIBOR borrowings at June 30, 2010). The Company also pays a commitment fee of 0.500% per annum, which may be reduced to 0.375% if certain leverage ratios are achieved, on the actual daily unused portions of the New Credit Facilities. The revolving credit facility under the New Credit Agreement matures, the commitments thereunder terminate, and all amounts then outstanding thereunder will be payable on February 11, 2014.

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The term loans under the New Credit Agreement are payable in equal quarterly principal installments aggregating 10% of the aggregate initial principal amount of the term loans in the first year, with the remaining outstanding principal balance of the term loans being payable in equal quarterly installments aggregating 10%, 10%, 15%, and 55% in the second, third, fourth, and fifth years, respectively. The net proceeds from certain asset sales, casualty/condemnation events, and certain incurrences of indebtedness (subject, in the cases of asset sales and casualty/condemnation events, to certain reinvestment rights), and a portion of the net proceeds from equity issuances and, under certain circumstances, the Company's excess cash flow, are required to be used to make prepayments in respect of loans outstanding under the New Credit Facilities. The term loans made under the New Credit Agreement mature, and all amounts then outstanding thereunder will be payable on February 11, 2015.

In connection with entering into the New Credit Agreement, the Company wrote-off unamortized deferred financing costs of approximately \$5.1 million incurred in connection with the Company's 2007 credit agreement. The Company also terminated its outstanding interest rate swap agreements, which resulted in a payment of approximately \$2.0 million to the swap counterparties. Such amounts are reflected as interest expense in the financial results of the Company for the six months ending June 30, 2010.

(13) Comprehensive Income

The following table presents details supporting the determination of comprehensive income for the three and six months ended June 30, 2010 and 2009 (in thousands):

| | Three Months Ended | | Six Months Ended | |
|--|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2010 | 2009 | 2010 | 2009 |
| Net income | \$ 55,775 | \$ 31,891 | \$ 89,576 | \$ 52,503 |
| Net unrealized gain on available for sale investment securities, net of tax | 2,223 | 14 | 1,992 | 138 |
| Net gain on interest rate swaps, net of tax | | 230 | 23 | 394 |
| Reclass of accumulated other comprehensive income on interest rate swap termination ⁽¹⁾ | | | 1,253 | |
| Comprehensive income, net of tax | \$ 57,998 | \$ 32,135 | \$ 92,844 | \$ 53,035 |

(1) Accumulated other comprehensive income balances related to interest rate swap derivatives were reclassified to interest expense and recognized in the three months ended

March 31, 2010.

See Note 8,

Derivatives .

(14) Segment Information

The Company reports its business in three segments: Medicare Advantage, stand-alone PDP, and Corporate. Medicare Advantage (MA-PD) consists of Medicare-eligible beneficiaries receiving healthcare benefits, including prescription drugs, through a coordinated care plan qualifying under Part C and Part D of the Medicare Program. Stand-alone PDP (PDP) consists of Medicare-eligible beneficiaries receiving prescription drug benefits on a stand-alone basis in accordance with Medicare Part D. The Corporate segment consists primarily of corporate expenses not allocated to the other reportable segments. These segment groupings are also consistent with information used by the Company's chief executive officer in making operating decisions.

The accounting policies of each segment are the same and are described in Note 1 to the 2009 Form 10-K. The results of each segment are measured and evaluated by earnings before interest expense, depreciation and amortization expense, and income taxes (EBITDA). The Company does not allocate certain corporate overhead amounts (classified as selling, general and administrative expenses, or SG&A) or interest expense to the segments. The Company evaluates interest expense, income taxes, and asset and liability details on a consolidated basis as these items are managed in a corporate shared service environment and are not the responsibility of segment operating management. Revenue includes premium revenue, management and other fee income, and investment income.

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Asset and equity details by reportable segment have not been disclosed, as the Company does not internally report such information.

Financial data by reportable segment for the three and six months ended June 30 is as follows (in thousands):

| | MA-PD | PDP | Corporate | Total |
|---|--------------|------------|-----------|--------------|
| Three months ended June 30, 2010 | | | | |
| Revenue | \$ 653,074 | \$ 115,395 | \$ 10 | \$ 768,479 |
| EBITDA | 99,371 | 4,162 | (6,203) | 97,330 |
| Depreciation and amortization expense | 6,238 | | 1,272 | 7,510 |
| Three months ended June 30, 2009 | | | | |
| Revenue | \$ 595,034 | \$ 87,496 | \$ 13 | \$ 682,543 |
| EBITDA | 64,263 | 3,302 | (5,731) | 61,834 |
| Depreciation and amortization expense | 6,366 | 20 | 1,256 | 7,642 |
| Six months ended June 30, 2010 | | | | |
| Revenue | \$ 1,284,024 | \$ 244,871 | \$ 26 | \$ 1,528,921 |
| EBITDA | 181,822 | (601) | (12,498) | 168,723 |
| Depreciation and amortization expense | 12,430 | 31 | 2,836 | 15,297 |
| Six months ended June 30, 2009 | | | | |
| Revenue | \$ 1,148,519 | \$ 180,114 | \$ 25 | \$ 1,328,658 |
| EBITDA | 116,241 | 2,256 | (12,398) | 106,099 |
| Depreciation and amortization expense | 12,722 | 40 | 2,404 | 15,166 |

As of January 1, 2010, the Company revised its methodology for allocating SG&A expenses within its prescription drug operations to its MA-PD and PDP segments, which resulted in allocating a greater share of such expenses to its PDP segment. As a result of these revisions, the segment EBITDA amounts for the 2009 period include reclassification adjustments between segments such that the periods presented are comparable.

The Company uses segment EBITDA as an analytical indicator for purposes of assessing segment performance, as is common in the healthcare industry. Segment EBITDA should not be considered as a measure of financial performance under generally accepted accounting principles and segment EBITDA, as presented, may not be comparable to other companies.

A reconciliation of reportable segment EBITDA to net income included in the consolidated statements of income for the three and six months ended June 30 is as follows (in thousands):

| | Three Months Ended | | Six Months Ended | |
|-------------------------------|--------------------|-----------|------------------|------------|
| | June 30, | | June 30, | |
| | 2010 | 2009 | 2010 | 2009 |
| EBITDA | \$ 97,330 | \$ 61,834 | \$ 168,723 | \$ 106,099 |
| Income tax expense | (31,791) | (18,331) | (51,625) | (30,179) |
| Interest expense | (2,254) | (3,970) | (12,225) | (8,251) |
| Depreciation and amortization | (7,510) | (7,642) | (15,297) | (15,166) |
| Net Income | \$ 55,775 | \$ 31,891 | \$ 89,576 | \$ 52,503 |

Table of Contents**Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations**

You should read the following discussion and analysis in conjunction with our condensed consolidated financial statements and related notes included elsewhere in this report and our audited consolidated financial statements and the notes thereto for the year ended December 31, 2009, appearing in our Annual Report on Form 10-K that was filed with the Securities and Exchange Commission (SEC) on February 11, 2010 (the 2009 Form 10-K). Statements contained in this Quarterly Report on Form 10-Q that are not historical fact are forward-looking statements that the company intends to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. Statements that are predictive in nature, that depend on or refer to future events or conditions, or that include words such as anticipates, believes, could, estimates, expects, intends, potential, predicts, projects, should, will, would, and similar expressions are forward-looking statements. The company cautions that forward-looking statements involve known and unknown risks, uncertainties, and other factors that may cause our actual results, performance, or achievements to be materially different from any future results, performance, or achievements expressed or implied by the forward-looking statements. Forward-looking statements reflect our current views with respect to future events and are based on assumptions and subject to risks and uncertainties. Given these uncertainties, you should not place undue reliance on these forward-looking statements. In evaluating any forward-looking statement, you should specifically consider the information set forth under the captions Special Note Regarding Forward-Looking Statements and Item 1A. Risk Factors in the 2009 Form 10-K and the information set forth under Cautionary Statement Regarding Forward-Looking Statements in our earnings and other press releases, as well as other cautionary statements contained elsewhere in this report, including the matters discussed in Critical Accounting Policies and Estimates. We undertake no obligation beyond that required by law to update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur in the future. You should read this report and the documents that we reference in this report and have filed as exhibits to this report completely and with the understanding that our actual future results may be materially different from what we expect.

Overview**General**

HealthSpring, Inc. (the company or HealthSpring) is one of the country's largest coordinated care plans whose primary focus is Medicare, the federal government-sponsored health insurance program for U.S. citizens aged 65 and older, qualifying disabled persons, and persons suffering from end-stage renal disease. We operate Medicare Advantage plans in Alabama, Florida, Georgia, Illinois, Mississippi, Tennessee, and Texas and offer Medicare Part D prescription drug plans on a national basis. The company also provides management services to physician practices. We sometimes refer to our Medicare Advantage plans, including plans providing prescription drug benefits, or MA-PD, collectively as Medicare Advantage plans and our stand-alone prescription drug plan as our PDP. For purposes of additional analysis, the company provides membership and certain financial information, including premium revenue and medical expense, for our Medicare Advantage (including MA-PD) and PDP plans.

Medicare premiums, including premiums paid to our PDP, account for substantially all of our revenue. As a consequence, our profitability is dependent on government funding levels for Medicare programs. The Centers for Medicare and Medicaid Services (CMS) is the federal agency responsible for overseeing the Medicare program. The company's Tennessee Medicare Advantage plan is currently undergoing an audit by CMS relating to compliance with CMS's risk score coding requirements (herein, the RADV Audit). In February 2010, the company responded to the RADV Audit information request, including retrieving and providing medical records that support diagnosis codes and risk scores relating to 2006 dates of service and 2007 plan premiums. The company is currently unable to predict the outcome of the RADV Audit, or to predict the amount of premiums, if any, that may be subject to repayment by the Tennessee plan to CMS.

Recent health insurance reform, as embodied in the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act (collectively, PPACA) signed by the President into law in March 2010, is projected to result in a significant reduction in federal spending on the Medicare Advantage program. In addition to Medicare Advantage funding cuts, PPACA reduces enrollment periods, establishes medical loss ratio, or MLR , minimum levels, ties certain rate and rebate benefits to quality ratings, and imposes federal premium taxes. These

changes may have a significant adverse impact on our business, including member growth prospects and financial results. Most of the provisions of PPACA that are material to our business phase in over a number of years and regulations defining and implementing key provisions of PPACA applicable to us are not yet developed. Consequently, we are currently unable to predict with any reasonable certainty or otherwise quantify the likely impact of PPACA on our business model, financial condition, or results of operations.

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We report our business in three segments: Medicare Advantage; PDP; and Corporate. The following discussion of our results of operations includes a discussion of revenue and certain expenses by reportable segment. See Segment Information below for additional information related thereto.

Results of Operations

The consolidated results of operations include the accounts of HealthSpring and its subsidiaries. The following table sets forth the consolidated statements of income data expressed in dollars (in thousands) and as a percentage of total revenue for each period indicated:

| | Three Months Ended June 30, | | | |
|-------------------------------------|------------------------------------|---------------|------------------|---------------|
| | 2010 | | 2009 | |
| Revenue: | | | | |
| Premium revenue | \$ 756,342 | 98.4% | \$ 671,450 | 98.4% |
| Management and other fees | 10,590 | 1.4 | 9,987 | 1.5 |
| Investment income | 1,547 | 0.2 | 1,106 | 0.1 |
| Total revenue | 768,479 | 100.0% | 682,543 | 100.0% |
| Operating expenses: | | | | |
| Medical expense | 604,933 | 78.7 | 558,403 | 81.8 |
| Selling, general and administrative | 66,216 | 8.6 | 62,306 | 9.1 |
| Depreciation and amortization | 7,510 | 1.0 | 7,642 | 1.1 |
| Interest expense | 2,254 | 0.3 | 3,970 | 0.6 |
| Total operating expenses | 680,913 | 88.6 | 632,321 | 92.6 |
| Income before income taxes | 87,566 | 11.4 | 50,222 | 7.4 |
| Income tax expense | (31,791) | (4.1) | (18,331) | (2.7) |
| Net income | \$ 55,775 | 7.3% | \$ 31,891 | 4.7% |

| | Six Months Ended June 30, | | | |
|-------------------------------------|----------------------------------|---------------|------------------|---------------|
| | 2010 | | 2009 | |
| Revenue: | | | | |
| Premium revenue | \$ 1,505,720 | 98.4% | \$ 1,306,046 | 98.3% |
| Management and other fees | 20,778 | 1.4 | 19,956 | 1.5 |
| Investment income | 2,423 | 0.2 | 2,656 | 0.2 |
| Total revenue | 1,528,921 | 100.0% | 1,328,658 | 100.0% |
| Operating expenses: | | | | |
| Medical expense | 1,217,452 | 79.6 | 1,088,002 | 81.9 |
| Selling, general and administrative | 142,746 | 9.3 | 134,557 | 10.1 |
| Depreciation and amortization | 15,297 | 1.0 | 15,166 | 1.1 |
| Interest expense | 12,225 | 0.9 | 8,251 | 0.7 |
| Total operating expenses | 1,387,720 | 90.8 | 1,245,976 | 93.8 |
| Income before income taxes | 141,201 | 9.2 | 82,682 | 6.2 |

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| | | | | |
|--------------------|-----------|-------|-----------|-------|
| Income tax expense | (51,625) | (3.3) | (30,179) | (2.3) |
| Net income | \$ 89,576 | 5.9% | \$ 52,503 | 3.9% |

Table of Contents**Membership**

Our primary source of revenue is monthly premium payments we receive based on membership enrolled in Medicare. The following table summarizes our membership as of the dates specified:

| | June 30, 2010 | December 31, 2009 | June 30, 2009 |
|--------------------------------------|--------------------------|------------------------------|--------------------------|
| <i>Medicare Advantage Membership</i> | | | |
| Alabama | 30,724 | 31,330 | 30,101 |
| Florida | 35,975 | 32,606 | 30,892 |
| Georgia | 741 | | |
| Illinois | 11,814 | 11,261 | 10,821 |
| Mississippi | 5,321 | 4,591 | 4,152 |
| Tennessee | 64,791 | 58,252 | 55,917 |
| Texas | 48,070 | 51,201 | 50,348 |
| Total | 197,436 | 189,241 | 182,231 |
| <i>Medicare PDP Membership</i> | 394,599 | 313,045 | 294,753 |

Medicare Advantage. Our Medicare Advantage membership increased by 8.3% to 197,436 members at June 30, 2010, as compared to 182,231 members at June 30, 2009, with membership gains in all our health plans except our Texas plan. Our Medicare Advantage net membership gain of 15,205 members since June 30, 2009 reflects both focused sales and marketing efforts through the annual open enrollment and election periods and better retention rates resulting from, we believe, the relative attractiveness of our various plans' benefits. Effective as of January 1, 2010, we also began operating Medicare Advantage plans in three counties in Northern Georgia. We currently anticipate small but incremental Medicare Advantage membership growth throughout the remainder of 2010 through the offering of products to beneficiaries whose enrollment is not restricted by lock-in rules, including age-ins, dual-eligibles, and beneficiaries eligible for one of our special needs plans (SNPs).

PDP. PDP membership increased by 33.9% to 394,599 members at June 30, 2010 as compared to 294,753 at June 30, 2009, primarily as a result of the auto-assignment of members at the beginning of the year. We do not actively market our PDP and have relied on CMS auto-assignments of dual-eligible beneficiaries for membership. We have continued to receive assignments or otherwise enroll dual-eligible beneficiaries in our PDP plans during lock-in and expect incremental growth for the balance of the year.

Comparison of the Three-Month Period Ended June 30, 2010 to the Three-Month Period Ended June 30, 2009 Revenue

Total revenue was \$768.5 million in the three-month period ended June 30, 2010 as compared with \$682.5 million for the same period in 2009, representing an increase of \$86.0 million, or 12.6%. The components of revenue were as follows:

Premium Revenue: Total premium revenue for the three months ended June 30, 2010 was \$756.3 million as compared with \$671.5 million in the same period in 2009, representing an increase of \$84.8 million, or 12.6%. The components of premium revenue and the primary reasons for changes were as follows:

Medicare Advantage: Medicare Advantage (including MA-PD) premiums were \$640.8 million for the three months ended June 30, 2010 as compared to \$583.2 million in the second quarter of 2009, representing an increase of \$57.6 million, or 9.9%. The increase in Medicare Advantage premiums in 2010 is primarily attributable to increases in membership. PMPM premiums for the 2010 second quarter averaged \$1,082, which is flat compared to the 2009 second quarter. PMPM premiums in the current quarter reflect increases related to member risk scores, offset by decreases in CMS-calculated base rates.

PDP: PDP premiums (after risk corridor adjustments) were \$115.4 million in the three months ended June 30, 2010 compared to \$87.4 million in the same period of 2009, an increase of \$28.0 million, or 32.0%. The increase in premiums for the 2010 second quarter is primarily the result of increases in membership. Our average PMPM premiums (after risk corridor adjustments) were \$98 in the 2010 second quarter, as compared to \$100 during the 2009 second quarter.

Table of Contents***Medical Expense***

Medicare Advantage. Medicare Advantage (including MA-PD) medical expense for the three months ended June 30, 2010 increased \$21.2 million, or 4.4%, to \$499.2 million from \$478.0 million for the comparable period of 2009, which is primarily attributable to membership increases in the 2010 period as compared to the 2009 period. For the three months ended June 30, 2010, the Medicare Advantage MLR was 77.9% versus 82.0% for the same period of 2009. The MLR improvement in the 2010 second quarter is primarily attributable to changes in benefit design and lower inpatient utilization, combined with premium revenue increases. Our Medicare Advantage medical expense calculated on a PMPM basis was \$843 for the three months ended June 30, 2010, compared with \$881 for the comparable 2009 quarter.

PDP. PDP medical expense for the three months ended June 30, 2010 increased \$25.6 million to \$105.2 million, compared to \$79.6 million in the same period last year. PDP MLR for the 2010 second quarter was 91.2%, compared to 91.1% in the 2009 second quarter.

Selling, General, and Administrative Expense

Selling, general, and administrative, or SG&A, expense for the three months ended June 30, 2010 was \$66.2 million as compared with \$62.3 million for the same prior year period, an increase of \$3.9 million, or 6.3%. The increase in the 2010 second quarter as compared to the prior year period is primarily the result of additional personnel costs. As a percentage of revenue, SG&A expense decreased approximately 50 basis points for the three months ended June 30, 2010 compared to the prior year period. As a result of the shortened 2011 enrollment period which will no longer permit enrollment elections after the calendar year end, the company will accelerate marketing expenses typically spread over the fourth quarter of the current year and first quarter of the subsequent year into the fourth quarter of 2010.

Interest Expense

Interest expense was \$2.3 million in the 2010 second quarter, compared with \$4.0 million in the 2009 second quarter. The decrease in the current quarter was the result of lower average debt amounts outstanding and lower interest rates compared to the 2009 second quarter. The weighted average interest rate incurred on our borrowings during the three months ended June 30, 2010 and 2009 were 5.1% and 6.1%, respectively (3.4% and 4.9%, respectively, exclusive of amortization of deferred financing costs and credit facility fees).

Income Tax Expense

For the three months ended June 30, 2010, income tax expense was \$31.8 million, reflecting an effective tax rate of 36.3%, versus \$18.3 million, reflecting an effective tax rate of 36.5%, for the same period of 2009. The company expects the effective tax rates for the full 2010 year will approximate 36.5%.

Comparison of the Six-Month Period Ended June 30, 2010 to the Six-Month Period Ended June 30, 2009***Revenue***

Total revenue was \$1.5 billion in the six-month period ended June 30, 2010 as compared with \$1.3 billion for the same period in 2009, representing an increase of \$200.2 million, or 15.1%. The components of revenue were as follows:

Premium Revenue: Total premium revenue for the six months ended June 30, 2010 was \$1.5 billion as compared with \$1.3 billion in the same period in 2009, representing an increase of \$199.7 million, or 15.3%. The components of premium revenue and the primary reasons for changes were as follows:

Medicare Advantage: Medicare Advantage (including MA-PD) premiums increased \$135.5 million, or 12.1%, to \$1.3 billion for the six months ended June 30, 2010 as compared to the same period of 2009. The increase in Medicare Advantage premiums in 2010 is primarily attributable to increases in membership. PMPM premiums for the current six month period averaged \$1,072, which reflects an increase of 1.0% as compared to the 2009 comparable period. The PMPM premium increase in the current period is primarily the result of increases related to member risk scores, which were partially offset by decreases in CMS-calculated base rates.

PDP: PDP premiums (after risk corridor adjustments) were \$244.9 million in the six months ended June 30, 2010 compared to \$179.9 million in the same period of 2009, an increase of \$65.0 million, or 36.1%. The increase in premiums for the current six month period is primarily the result of increases in membership. Our average PMPM premiums (after risk corridor adjustments) were \$105 in the current six month period, as compared to \$104 during the

2009 comparable period.

Table of Contents***Medical Expense***

Medicare Advantage. Medicare Advantage (including MA-PD) medical expense for the six months ended June 30, 2010 increased \$65.6 million, or 7.1%, to \$983.9 million from \$918.3 million for the comparable period of 2009, which is primarily attributable to membership increases in the 2010 period as compared to the 2009 period. For the six months ended June 30, 2010, the Medicare Advantage MLR was 78.1% versus 81.7% for the same period of 2009.

The MLR improvement in the current period is primarily attributable to changes in benefit design and lower inpatient utilization, combined with premium revenue increases. Our Medicare Advantage medical expense calculated on a PMPM basis was \$837 for the six months ended June 30, 2010, compared with \$867 for the comparable 2009 period.

PDP. PDP medical expense for the six months ended June 30, 2010 increased \$64.7 million to \$232.9 million, compared to \$168.2 million in the same period last year. PDP MLR for the 2010 six month period was 95.1%, compared to 93.5% in the same period in 2009. The increase in PDP MLR for the current period was primarily attributable to changes in benefit design and increased transition prescription drug costs in the 2010 period.

Selling, General, and Administrative Expense

SG&A expense for the six months ended June 30, 2010 was \$142.7 million as compared with \$134.6 million for the same prior year period, an increase of \$8.1 million, or 6.1%. The increase in the 2010 period as compared to the prior year period is primarily the result of additional personnel costs, increases in sales commissions attributable to membership growth, and increases in advertising costs. As a percentage of revenue, SG&A expense decreased approximately 80 basis points for the six months ended June 30, 2010 compared to the prior year period.

Interest Expense

Interest expense was \$12.2 million in the 2010 six month period, compared with \$8.3 million in the 2009 same period. The company's interest expense in the 2010 period includes debt extinguishment costs of \$7.1 million resulting from the company's entering into a new credit facility and terminating its prior credit facility during the first quarter. Net of extinguishment costs, interest expense decreased \$3.2 million in the 2010 period, reflecting lower average debt amounts outstanding and lower interest rates compared to the 2009 period. The weighted average interest rate incurred on our borrowings during the six month periods ended June 30, 2010 and 2009 were 5.3% and 6.2%, respectively (3.7% and 5.1%, respectively, exclusive of amortization of deferred financing costs and credit facility fees).

Income Tax Expense

For the six months ended June 30, 2010, income tax expense was \$51.6 million, reflecting an effective tax rate of 36.6%, versus \$30.2 million, reflecting an effective tax rate of 36.5%, for the same period of 2009.

Segment Information

We report our business in three segments: Medicare Advantage, stand-alone PDP, and Corporate. Medicare Advantage (MA-PD) consists of Medicare-eligible beneficiaries receiving healthcare benefits, including prescription drugs, through a coordinated care plan qualifying under Part C and Part D of the Medicare Program. Stand-alone PDP consists of Medicare-eligible beneficiaries receiving prescription drug benefits on a stand-alone basis in accordance with Medicare Part D. The Corporate segment consists primarily of corporate expenses not allocated to the other reportable segments. These segment groupings are also consistent with information used by our chief executive officer in making operating decisions.

The results of each segment are measured and evaluated by earnings before interest expense, depreciation and amortization expense, and income taxes (EBITDA). We do not allocate certain corporate overhead amounts (classified as SG&A expense) or interest expense to our segments. We evaluate interest expense, income taxes, and asset and liability details on a consolidated basis as these items are managed in a corporate shared service environment and are not the responsibility of segment operating management.

Revenue includes premium revenue, management and other fee income, and investment income.

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Asset and equity details by reportable segment have not been disclosed, as the company does not internally report such information.

Financial data by reportable segment for the three and six months ended June 30 is as follows (in thousands):

| | MA-PD | PDP | Corporate | Total |
|---|--------------|------------|-----------|--------------|
| Three months ended June 30, 2010 | | | | |
| Revenue | \$ 653,074 | \$ 115,395 | \$ 10 | \$ 768,479 |
| EBITDA | 99,371 | 4,162 | (6,203) | 97,330 |
| Depreciation and amortization expense | 6,238 | | 1,272 | 7,510 |
| Three months ended June 30, 2009 | | | | |
| Revenue | \$ 595,034 | \$ 87,496 | \$ 13 | \$ 682,543 |
| EBITDA | 64,263 | 3,302 | (5,731) | 61,834 |
| Depreciation and amortization expense | 6,366 | 20 | 1,256 | 7,642 |
| Six months ended June 30, 2010 | | | | |
| Revenue | \$ 1,284,024 | \$ 244,871 | \$ 26 | \$ 1,528,921 |
| EBITDA | 181,822 | (601) | (12,498) | 168,723 |
| Depreciation and amortization expense | 12,430 | 31 | 2,836 | 15,297 |
| Six months ended June 30, 2009 | | | | |
| Revenue | \$ 1,148,519 | \$ 180,114 | \$ 25 | \$ 1,328,658 |
| EBITDA | 116,241 | 2,256 | (12,398) | 106,099 |
| Depreciation and amortization expense | 12,722 | 40 | 2,404 | 15,166 |

As of January 1, 2010, the company revised its methodology for allocating selling, general, and administrative expenses within its prescription drug operations to its MA-PD and PDP segments, which resulted in allocating a greater share of such expenses to its PDP segment. As a result of these revisions, the segment EBITDA amounts for the 2009 period includes reclassification adjustments between segments such that the periods presented are comparable.

We use segment EBITDA as an analytical indicator for purposes of assessing segment performance, as is common in the healthcare industry. Segment EBITDA should not be considered as a measure of financial performance under generally accepted accounting principles and segment EBITDA, as presented, may not be comparable to other companies.

A reconciliation of reportable segment EBITDA to net income included in the consolidated statements of income for the three and six months ended June 30 is as follows (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|-------------------------------|--------------------------------|-----------|------------------------------|------------|
| | 2010 | 2009 | 2010 | 2009 |
| EBITDA | \$ 97,330 | \$ 61,834 | \$ 168,723 | \$ 106,099 |
| Income tax expense | (31,791) | (18,331) | (51,625) | (30,179) |
| Interest expense | (2,254) | (3,970) | (12,225) | (8,251) |
| Depreciation and amortization | (7,510) | (7,642) | (15,297) | (15,166) |
| Net Income | \$ 55,775 | \$ 31,891 | \$ 89,576 | \$ 52,503 |

Liquidity and Capital Resources

We finance our operations primarily through internally generated funds. We generate cash primarily from premium revenue and our primary uses of cash are payment of medical and SG&A expenses and principal and interest on

indebtedness. We anticipate that our current level of cash on hand, internally generated cash flows, and borrowings available under our revolving credit facility will be sufficient to fund our working capital needs, our debt service, and anticipated capital expenditures over at least the next twelve months.

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The reported changes in cash and cash equivalents for the six month period ended June 30, 2010, compared to the same period of 2009, were as follows (in thousands):

| | Six Months Ended | |
|--|-------------------------|-------------|
| | June 30, | |
| | 2010 | 2009 |
| Net cash used in operating activities | \$ (40,794) | \$ (7,945) |
| Net cash used in investing activities | (236,080) | (16,141) |
| Net cash (used in) provided by financing activities | (58,852) | 36,856 |
| Net (decrease) increase in cash and cash equivalents | \$ (335,726) | \$ 12,770 |

We will receive risk premium settlement payments from CMS of approximately \$119.7 million in the 2010 third quarter.

Cash Flows from Operating Activities

Our primary sources of liquidity are cash flows provided by our operations and available cash on hand. To date, we have not had to borrow under our \$175.0 million revolving credit facility to fund operating activities. We used cash in operating activities of \$40.8 million during the six months ended June 30, 2010, compared to using cash of \$7.9 million during the six months ended June 30, 2009. The negative variance in cash flow from operations for the 2010 period compared to the 2009 period is primarily the result of the increase in risk payments due from CMS and the timing of drug rebate collections in the 2010 period. Cash flows from operations typically lag net income for the first half of the year as a result of the timing and amount of risk adjustment payments from CMS.

Cash Flows from Investing and Financing Activities

For the six months ended June 30, 2010, the primary investing activities consisted of expenditures of \$359.8 million to purchase investment securities and restricted investments, the receipt of \$129.8 million in proceeds from the sale or maturity of investment securities and restricted investments, and \$5.5 million spent on property and equipment additions. The investing activity in the prior year period consisted primarily of \$38.8 million to purchase investment securities, the receipt of \$29.1 million in proceeds from the maturity of investment securities, and \$5.5 million in property and equipment additions.

During the six months ended June 30, 2010, the company's financing activities consisted primarily of the receipt of \$200.0 million in proceeds from the issuance of debt, the expenditure of \$266.3 million for the repayment of existing long-term debt, and \$28.5 million of funds received in excess of funds withdrawn from CMS for the benefit of members. The financing activity in the prior year period consisted primarily of \$53.5 million of funds received in excess of funds withdrawn from CMS for the benefit of members, and \$16.7 million for the repayment of long-term debt. Funds due (held) for the benefit of members from CMS are recorded on our balance sheet at June 30, 2010 and at December 31, 2009. We anticipate settling approximately \$1.4 million of such Part D related amounts (including risk corridor settlements) relating to 2009 with CMS during the second half of 2010 as part of the final settlement of Part D payments for the 2009 plan year.

Cash and Cash Equivalents

At June 30, 2010, the company's cash and cash equivalents were \$103.7 million, \$56.3 million of which was held in unregulated subsidiaries. Approximately \$28.6 million of the regulated subsidiary cash balance relates to amounts held by the company for the benefit of its Part D members, which we expect to settle with CMS during the second half of 2011.

Substantially all of the company's liquidity is in the form of cash and cash equivalents (\$103.7 million at June 30, 2010), a portion of which (\$47.4 million at June 30, 2010) is held by the company's regulated insurance subsidiaries, which amounts are required by law and by our credit agreement to be invested in low-risk, short-term, highly-liquid investments (such as government securities, money market funds, deposit accounts, and overnight repurchase agreements). The company also invests in securities (\$323.3 million at June 30, 2010), primarily corporate, asset-backed and government debt securities, that it generally intends, and has the ability, to hold to maturity. Because

the company is not relying on these investment securities for near-term liquidity, short term fluctuations in market pricing generally do not affect the company's ability to meet its liquidity needs. To date, the company has not experienced any material issuer defaults on its investment securities.

Table of Contents**Statutory Capital Requirements**

The company's regulated insurance subsidiaries are required to maintain satisfactory minimum net worth requirements established by their respective state departments of insurance. At June 30, 2010, the statutory minimum net worth requirements and actual statutory net worth were \$18.5 million and \$108.9 million for the Tennessee HMO; \$1.1 million and \$54.5 million for the Alabama HMO; \$10.6 million and \$27.8 million for the Florida HMO; \$38.4 million (at 200% of authorized control level) and \$83.5 million for the Texas HMO; and \$14.6 million (at 200% of authorized control level) and \$37.0 million for the accident and health subsidiary, respectively. Each of these subsidiaries was in compliance with applicable statutory requirements as of June 30, 2010. Notwithstanding the foregoing, the state departments of insurance can require our regulated insurance subsidiaries to maintain minimum levels of statutory capital in excess of amounts required under the applicable state law if they determine that maintaining additional statutory capital is in the best interest of the company's members. In addition, as a condition to its approval of the LMC Health Plans acquisition, The Florida Office of Insurance Regulation has required the Florida plan to maintain 115% of the statutory surplus otherwise required by Florida law until September 2010. The regulated insurance subsidiaries are restricted from making distributions without appropriate regulatory notifications and approvals or to the extent such dividends would put them out of compliance with statutory net worth requirements.

Indebtedness

Long-term debt at June 30, 2010 and December 31, 2009 consists of the following (in thousands):

| | June 30, 2010 | December 31, 2009 |
|---|--------------------------|------------------------------|
| Credit agreement | \$ 170,625 | \$ 236,973 |
| Less: current portion of long-term debt | (17,500) | (43,069) |
| Long-term debt less current portion | \$ 153,125 | \$ 193,904 |

On February 11, 2010, the company entered into a \$350.0 million credit agreement (the "New Credit Agreement"), which, subject to the terms and conditions set forth therein, provides for a five-year, \$175.0 million term loan credit facility and a four-year, \$175.0 million revolving credit facility (the "New Credit Facilities"). Proceeds from the New Credit Facilities, together with cash on hand, were used to fund the repayment of \$237.0 million in term loans outstanding under the company's 2007 credit agreement as well as transaction expenses related thereto.

Borrowings under the New Credit Agreement accrue interest on the basis of either a base rate or a LIBOR rate plus, in each case, an applicable margin depending on the company's debt-to-EBITDA leverage ratio (275 basis points for LIBOR borrowings at June 30, 2010). The company also pays a commitment fee of 0.500% per annum, which may be reduced to 0.375% if certain leverage ratios are achieved, on the actual daily unused portions of the New Credit Facilities. The revolving credit facility under the New Credit Agreement matures, the commitments thereunder terminate, and all amounts then outstanding thereunder will be payable on February 11, 2014. As of the date of this report the revolving credit agreement was undrawn.

In connection with entering into the New Credit Agreement, the company wrote-off unamortized deferred financing costs of approximately \$5.1 million incurred in connection with the 2007 credit agreement. The company also terminated both interest rate swap agreements, which resulted in a payment of approximately \$2.0 million to the swap counterparties. Such amounts are classified as interest expense and are reflected in the financial results of the company for the six months ended June 30, 2010.

Off-Balance Sheet Arrangements

At June 30, 2010, we did not have any off-balance sheet arrangement requiring disclosure.

Contractual Obligations

We did not experience any material changes to contractual obligations outside the ordinary course of business during the six months ended June 30, 2010.

Table of Contents**Critical Accounting Policies and Estimates**

The preparation of our consolidated financial statements requires our management to make a number of estimates and assumptions relating to the reported amount of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the period. Our estimates are based on historical experience and on various other assumptions that we believe are reasonable under the circumstances. Changes in estimates are recorded if and when better information becomes available. As future events and their effects cannot be determined with precision, actual results could differ significantly from these estimates. Changes in estimates resulting from continuing changes in the economic environment will be reflected in the financial statements in future periods.

We believe that the accounting policies discussed below are those that are most important to the presentation of our financial condition and results of operations and that require our management's most difficult, subjective, and complex judgments. For a more complete discussion of these and other critical accounting policies and estimates of the company, see our 2009 Form 10-K.

Medical Expense and Medical Claims Liability

Medical expense is recognized in the period in which services are provided and includes an estimate of the cost of medical expense that has been incurred but not yet reported, or IBNR. Medical expense includes claim payments, capitation payments, risk sharing payments and pharmacy costs, net of rebates, as well as estimates of future payments of claims incurred, net of reinsurance. Capitation payments represent monthly contractual fees disbursed to physicians and other providers who are responsible for providing medical care to members. Pharmacy costs represent payments for members' prescription drug benefits, net of rebates from drug manufacturers. Rebates are recognized when earned, according to the contractual arrangements with the respective vendors. Premiums we pay to reinsurers are reported as medical expense and related reinsurance recoveries are reported as deductions from medical expense.

Medical claims liability includes medical claims reported to the plans but not yet paid as well as an actuarially determined estimate of claims that have been incurred but not yet reported.

The IBNR component of total medical claims liability is based on our historical claims data, current enrollment, health service utilization statistics, and other related information. Estimating IBNR is complex and involves a significant amount of judgment. Accordingly, it represents our most critical accounting estimate. The development of the IBNR includes the use of standard actuarial developmental methodologies, including completion factors and claims trends, which take into account the potential for adverse claims developments, and considers favorable and unfavorable prior period developments. Actual claims payments will differ, however, from our estimates. A worsening or improvement of our claims trend or changes in completion factors from those that we assumed in estimating medical claims liabilities at June 30, 2010 would cause these estimates to change in the near term and such a change could be material.

As discussed above, actual claim payments will differ from our estimates. The period between incurrence of the expense and payment is, as with most health insurance companies, relatively short, however, with over 90% of claims typically paid within 60 days of the month in which the claim is incurred. Although there is a risk of material variances in the amounts of estimated and actual claims, the variance is known quickly. Accordingly, we expect that substantially all of the estimated medical claims payable as of the end of any fiscal period (whether a quarter or year end) will be known and paid during the next fiscal period.

Our policy is to record the best estimate of medical expense IBNR. Using actuarial models, we calculate a minimum amount and maximum amount of the IBNR component. To most accurately determine the best estimate, our actuaries determine the point estimate within their minimum and maximum range by similar medical expense categories within lines of business. The medical expense categories we use are in-patient facility, outpatient facility, all professional expense, and pharmacy.

We apply different estimation methods depending on the month of service for which incurred claims are being estimated. For the more recent months, which account for the majority of the amount of IBNR, we estimate our claims incurred by applying the observed trend factors to the trailing twelve-month PMPM costs. For prior months, costs have been estimated using completion factors. In order to estimate the PMPMs for the most recent months, we validate our estimates of the most recent months' utilization levels to the utilization levels in older months using

actuarial techniques that incorporate a historical analysis of claim payments, including trends in cost of care provided, and timeliness of submission and processing of claims.

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The following table illustrates the sensitivity of the completion and claims trend factors and the impact on our operating results caused by changes in these factors that management believes are reasonably likely based on our historical experience and June 30, 2010 data (dollars in thousands):

| Completion Factor (a) | | Claims Trend Factor (b) | |
|--|--|--|--|
| Increase (Decrease) in Factor | Increase (Decrease) in Medical Claims Liability | Increase (Decrease) in Factor | Increase (Decrease) in Medical Claims Liability |
| 3% | \$ (5,089) | (3)% | \$ (2,890) |
| 2 | (3,432) | (2) | (1,924) |
| 1 | (1,736) | (1) | (961) |
| (1) | 1,777 | 1 | 958 |

- (a) Impact due to change in completion factor for the most recent three months. Completion factors indicate how complete claims paid to date are in relation to estimates for a given reporting period. Accordingly, an increase in completion factor results in a decrease in the remaining estimated liability for medical claims.
- (b) Impact due to change in annualized medical cost trends used to estimate PMPM costs for the most recent

three months.

Each month, we re-examine the previously established medical claims liability estimates based on actual claim submissions and other relevant changes in facts and circumstances. As the liability estimates recorded in prior periods become more exact, we increase or decrease the amount of the estimates, and include the changes in medical expenses in the period in which the change is identified. In every reporting period, our operating results include the effects of more completely developed medical claims liability estimates associated with prior periods.

In establishing medical claims liability, we also consider premium deficiency situations and evaluate the necessity for additional related liabilities. There were no required premium deficiency accruals at June 30, 2010 or December 31, 2009.

Premium Revenue Recognition

We generate revenues primarily from premiums we receive from CMS to provide healthcare benefits to our members. We receive premium payments on a PMPM basis from CMS to provide healthcare benefits to our Medicare members, which premiums are fixed (subject to retroactive risk adjustment) on an annual basis by contracts with CMS.

Although the amount we receive from CMS for each member is fixed, the amount varies among Medicare plans according to, among other things, plan benefits, demographics, geographic location, age, gender, and the relative risk score of the membership.

We generally receive premiums on a monthly basis in advance of providing services. Premiums collected in advance are deferred and reported as deferred revenue. We recognize premium revenue during the period in which we are obligated to provide services to our members. Any amounts that have not been received are recorded on the balance sheet as accounts receivable.

Our Medicare premium revenue is subject to periodic adjustment under what is referred to as CMS's risk adjustment payment methodology based on the health risk of our members. Risk adjustment uses health status indicators to correlate the payments to the health acuity of the member, and consequently establishes incentives for plans to enroll and treat less healthy Medicare beneficiaries. Under the risk adjustment payment methodology, coordinated care plans must capture, collect, and report diagnosis code information to CMS. After reviewing the respective submissions, CMS establishes the payments to Medicare plans generally at the beginning of the calendar year, and then adjusts premium levels on two separate occasions on a retroactive basis. The first retroactive risk premium adjustment for a given fiscal year generally occurs during the third quarter of such fiscal year. This initial settlement (the Initial CMS Settlement) represents the updating of risk scores for the current year based on the prior year's dates of service. CMS then issues a final retroactive risk premium adjustment settlement for that fiscal year in the following year (the Final CMS Settlement). We estimate and record on a monthly basis both the Initial CMS Settlement and the Final CMS Settlement.

We develop our estimates for risk premium adjustment settlement utilizing historical experience and predictive actuarial models as sufficient member risk score data becomes available over the course of each CMS plan year. Our actuarial models are populated with available risk score data on our members. Risk premium adjustments are based on member risk score data from the previous year. Risk score data for members who entered our plans during the current plan year, however, is not available for use in our models; therefore, we make assumptions regarding the risk scores of this subset of our member population.

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All such estimated amounts are periodically updated as additional diagnosis code information is reported to CMS and adjusted to actual amounts when the ultimate adjustment settlements are either received from CMS or the company receives notification from CMS of such settlement amounts.

As a result of the variability of factors, including plan risk scores, that determine such estimations, the actual amount of CMS's retroactive risk premium settlement adjustments could be materially more or less than our estimates. Consequently, our estimate of our plans' risk scores for any period and our accrual of settlement premiums related thereto, may result in favorable or unfavorable adjustments to our Medicare premium revenue and, accordingly, our profitability. There can be no assurance that any such differences will not have a material effect on any future quarterly or annual results of operations.

The following table illustrates the sensitivity of the Final CMS Settlements and the impact on premium revenue caused by differences between actual and estimated settlement amounts that management believes are reasonably likely, based on our historical experience and premium revenue for the six months ending June 30, 2010 (dollars in thousands):

| Increase (Decrease) in Estimate | Increase (Decrease) In Settlement Receivable |
|--|---|
| 1.5% | \$ 18,705 |
| 1.0 | 12,470 |
| 0.5 | 6,235 |
| (0.5) | (6,235) |

Goodwill and Indefinite-Life Intangible Assets

Goodwill represents the excess of cost over fair value of assets of businesses acquired. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead are tested for impairment at least annually. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value. This determination is made at the reporting unit level and consists of two steps. First, the company determines the fair value of the reporting unit and compares it to its carrying amount. Second, if the carrying amount of the reporting unit exceeds its fair value, an impairment loss is recognized for any excess of the carrying amount of the unit's goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting units in a manner similar to a purchase price allocation. The residual fair value after this allocation is the implied fair value of the reporting unit's goodwill. Goodwill currently exists at four of our reporting units—Alabama, Florida, Tennessee and Texas.

Goodwill valuations have been determined using an income approach based on the present value of future cash flows of each reporting unit. In assessing the recoverability of goodwill, we consider historical results, current operating trends and results, and we make estimates and assumptions about premiums, medical cost trends, margins and discount rates based on our budgets, business plans, economic projections, anticipated future cash flows and regulatory data. Each of these factors contains inherent uncertainties and management exercises substantial judgment and discretion in evaluating and applying these factors.

Although we believe we have sufficient current and historical information available to us to test for impairment, it is possible that actual cash flows could differ from the estimated cash flows used in our impairment tests. We could also be required to evaluate the recoverability of goodwill prior to the annual assessment if we experience various triggering events, including significant declines in margins or sustained and significant market capitalization declines. These types of events and the resulting analyses could result in goodwill impairment charges in the future. Impairment charges, although non-cash in nature, could adversely affect our financial results in the periods of such charges. In addition, impairment charges may limit our ability to obtain financing in the future.

Table of Contents**Item 3: Quantitative and Qualitative Disclosures About Market Risk**

As of June 30, 2010 and December 31, 2009, we had the following assets that may be sensitive to changes in interest rates:

| Asset Class | June 30, 2010 | December 31, 2009 |
|--|------------------|----------------------|
| | (in thousands) | |
| Investment securities, available for sale: | | |
| Current portion | \$ | \$ 8,883 |
| Non-current portion | 259,875 | 13,574 |
| Investment securities, held to maturity: | | |
| Current portion | | 13,965 |
| Non-current portion | 42,567 | 38,463 |
| Restricted investments | 20,856 | 16,375 |

We have not purchased any of our investments for trading purposes. Investment securities, which consist primarily of debt securities, have been categorized as either available for sale or held to maturity. Held to maturity securities are those securities that the company does not intend to sell, nor expect to be required to sell, prior to maturity. At June 30, 2010, investment securities are classified as non-current assets based on the company's intention to reinvest such assets upon sale or maturity and to not use such assets in current operations. At December 31, 2009, the company classified its investment securities based upon maturity dates. These investment securities consist of highly liquid government and corporate debt obligations, the majority of which mature in five years or less. The investments are subject to interest rate risk and will decrease in value if market rates increase. Because of the relatively short-term nature of our investments and our portfolio mix of variable and fixed rate investments, however, we would not expect the value of these investments to decline significantly as a result of a sudden change in market interest rates. Moreover, because of our intention not to sell these investments prior to their maturity, we would not expect foreseeable changes in interest rates to materially impair their carrying value. Restricted investments consist of deposits, certificates of deposit, government securities, and mortgage backed securities, deposited or pledged to state departments of insurance in accordance with state rules and regulations. At June 30, 2010 and December 31, 2009, these restricted assets are recorded at amortized cost and classified as long-term regardless of the contractual maturity date because of the restrictive nature of the states' requirements.

Assuming a hypothetical and immediate 1% increase in market interest rates at June 30, 2010, the fair value of our fixed income investments would decrease by approximately \$8.5 million. Similarly, a 1% decrease in market interest rates at June 30, 2010 would result in an increase of the fair value of our investments of approximately \$8.0 million. Unless we determined, however, that the increase in interest rates caused more than a temporary impairment in our investments, or unless we were compelled by a currently unforeseen reason to sell securities, such a change should not affect our future earnings or cash flows.

We are subject to market risk from exposure to changes in interest rates based on our financing, investing, and cash management activities. At June 30, 2010, we had \$170.6 million of outstanding indebtedness, bearing interest at variable rates at specified margins above either the agent bank's alternate base rate or its LIBOR rate, at our election. Holding other variables constant, including levels of indebtedness, a 0.125% increase in interest rates would have an estimated negative impact on pre-tax earnings and cash flows for the next twelve month period of \$213,000. Although changes in the alternate base rate or the LIBOR rate would affect the costs of funds borrowed in the future, we believe the effect, if any, of reasonably possible near-term changes in interest rates on our consolidated financial position, results of operations or cash flow would not be material.

At December 31, 2009, we had interest rate swap agreements to manage a portion of our exposure to these fluctuations. The interest rate swaps converted a portion of our indebtedness to a fixed rate with a notional amount of \$100.0 million. The company designated its interest rate swaps as cash flow hedges which were recorded in the company's consolidated balance sheet at their fair value. The fair value of the company's interest rate swaps at December 31, 2009 were reflected as a liability of approximately \$2.1 million and were included in other current

liabilities in the accompanying consolidated balance sheet. In connection with the New Credit Agreement, the interest rate swap agreements were terminated and approximately \$2.0 million was paid by us to the swap counterparties to settle the terminations. As of June 30, 2010, we had not taken any other action to cover interest rate risk and were not a party to any interest rate market risk management activities. We may re-enter into interest rate swap agreements in the future depending on market conditions and other factors.

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Item 4: Controls and Procedures

Our senior management carried out the evaluation required by Rule 13a-15 under the Exchange Act, under the supervision and with the participation of our Chief Executive Officer (CEO) and Chief Financial Officer (CFO), of the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act (Disclosure Controls). Based on the evaluation, our senior management, including our CEO and CFO, concluded that, as of June 30, 2010, our Disclosure Controls were effective.

There has been no change in our internal control over financial reporting identified in connection with the evaluation that occurred during the quarter ended June 30, 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Our management, including our CEO and CFO, does not expect that our Disclosure Controls and internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, with the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error and mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of controls.

The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, a control may become inadequate because of changes in conditions or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and may not be detected.

Table of Contents**PART II OTHER INFORMATION****Item 1. Legal Proceedings.**

We are not currently involved in any pending legal proceeding that we believe is material to our financial condition or results of operations. We are, however, involved from time to time in routine legal matters and other claims incidental to our business, including employment-related claims; claims relating to our health plans contractual relationships with providers, members, and vendors; and claims relating to marketing practices of sales agents and agencies that are employed by, or independent contractors to, our health plans.

Item 1A. Risk Factors.

In addition to the other information set forth in this report, you should consider carefully the risks and uncertainties previously reported and described under the captions Part I Item 1A. Risk Factors in the 2009 Form 10-K and Part II Item 1A. Risk Factors in our Quarterly Report on Form 10-Q for the quarter ended March 31, 2010 (2010 First Quarter 10-Q), the occurrence of any of which could materially and adversely affect our business, prospects, financial condition, and operating results. The risks previously reported and described in our 2009 Form 10-K and 2010 First Quarter 10-Q are not the only risks facing our business. Additional risks and uncertainties not currently known to us or that we currently consider to be immaterial also could materially and adversely affect our business, prospects, financial condition, and operating results.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

In May 2010, the Company's Board of Directors authorized a stock repurchase program to repurchase up to \$100.0 million of the Company's common stock. The program authorizes purchases made from time to time in either the open market or through privately negotiated transactions, in accordance with SEC and other applicable legal requirements. The timing, prices, and sizes of purchases depend upon prevailing stock prices, general economic and market conditions, and other factors. Funds for the repurchase of shares have, and are expected to, come primarily from unrestricted cash on hand and unrestricted cash generated from operations. The repurchase program does not obligate the Company to acquire any particular amount of common stock and the repurchase program may be suspended at any time at the Company's discretion. The program is scheduled to expire on June 30, 2011. During the quarter ended June 30, 2010, the Company repurchased the following shares of its common stock pursuant to the Company's \$100.0 million stock repurchase program:

Issuer Purchases of Equity Securities

| Period | Total Number of Shares Purchased | Average Price Paid per Share (\$) | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (\$) |
|---------------------|----------------------------------|-----------------------------------|--|---|
| 04/01/10 - 04/30/10 | | | | |
| 05/01/10 - 05/31/10 | 837,634 | 17.10 | 837,634 | 85,696,320 |
| 06/01/10 - 06/30/10 | | | | |
| Total | 837,634 | 17.10 | 837,634 | 85,696,320 |

Our ability to purchase common stock and to pay cash dividends is limited by our credit agreement. As a holding company, our ability to repurchase common stock and to pay cash dividends is also dependent on the availability of cash dividends from our regulated HMO subsidiaries, which are restricted by the laws of the states in which we operate and CMS, as well as limitations under our credit agreement.

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Item 3. Defaults Upon Senior Securities.

Inapplicable.

Item 5. Other Information.

Inapplicable.

Item 6. Exhibits.

See Exhibit Index following signature page.

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

HEALTHSPRING, INC.

Date: July 30, 2010

By: /s/ Karey L. Witty
Karey L. Witty
Executive Vice President and Chief
Financial Officer (Principal Financial
and Accounting Officer)

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EXHIBIT INDEX

| | |
|------|---|
| 10.1 | Non-Employee Director Compensation Policy* |
| 31.1 | Certifications of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certifications of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

* Indicates management contract or compensatory plan, contract, or arrangement.