

SMITH INTERNATIONAL, INC.

Post Office Box 1860
Newport Beach, California 92660
Phone (714) 752-9000 Telex: 4996871

Ronald R. Randall
General Counsel
Secretary

May 11, 1987

Ida Rose Langord Hall
1711 N. Lambert Lane
Provo, Utah 84601

Re: In re Smith International, Inc:
Agreement and Plan of Merger
(Megadiamond Industries, Inc.)

Dear Ms. Hall:

Following my letter of February 11, 1987, to the Former Shareholders of Megadiamond (the "Notification Letter") a meeting was held between representatives of Smith International, Inc. (the "Company") and the Shareholders to discuss the details of the write-offs set forth in the Notification Letter and the propriety of claiming the Indemnity Funds and setting-off the excess write-offs against the forthcoming milestone payment.

As a result of the meeting, the Company has agreed to modify the terms set forth in the Notification Letter as follows:

1. The interest accrued on the First Indemnity Fund will be applied to the total claimed by the Company. As of the end of April the fund plus accrued interest amounted to \$154,768. The amount by which the First Indemnity Fund is "insufficient" is therefore reduced from \$415,474 to \$398,706.
2. The Former Shareholders will receive any proceeds which might be realized from the sale of the inventory which was written-off up to the amount of the net write-off (\$415,822). A special effort will be made at Megadiamond to sell the inventory.

May 11, 1987

Page Two

3. The Former Shareholders will receive any excess value recovered by Megadiamond upon the sale of its ownership interest in Diamond Distributors France, S.A. ("DDF"). Such excess value shall be determined by first deducting Megadiamond's basis in DDF from the net proceeds of any such sale but shall not exceed the net write-off due to accounts receivable set forth in the Notification Letter (\$137,652).

The foregoing agreement to return recoveries under items 2 and 3 above shall be effective until December 31, 1990 and December 31, 1993 respectively. Any recovery shall be calculated within ninety (90) days of the close of Megadiamond's books at year end and shall be included in the first milestone payment due Former Shareholders thereafter. In the event no milestone payment shall be made during the calendar year in which the calculation is made, the Company will distribute the funds to Shareholders at the end of such year.

Several matters involving contract administration, milestone definitions and milestone status were also discussed at the meeting.

- a. Gene Meyers, at Megadiamond, was appointed as the "Contract Administrator" for Article Three of the Agreement and Plan of Merger (the "Merger Agreement"). Gene will maintain a constant awareness of all matters relating to milestones and will prepare the annual certificate to shareholders required pursuant to Section 13.5 of the Merger Agreement. All inquiries regarding milestones may be directed to Gene.
- b. The "TCI Enhanced Inserts" milestone [Section 3.2(iii)(a)(2)]:

The Company has been including all inserts delivered to both its Smith Tool and Smith Gruner divisions in its calculations and expects the milestone will have been met when the books are closed for the month of April. The milestone payment of \$1,850,000 less set-offs described in the Notification Letter, as modified herein, will be distributed during the month of June if the milestone in fact was achieved.

May 11, 1987

Page Three

- c. The "Hardfacing Material" milestone [Section 3.2(iii)(b)]:

The original understanding of the definition of "Hardfacing Material" was diamond or PCD grit. It was intended that this milestone would be met when a premium "journal bearing" type drill bit, incorporating the material, became a standard product for Smith Tool as defined in the milestone or when \$100,000 worth of the material had been delivered to Smith Tool. It appears, however, that the most effective means of providing improved wear resistance in a milled tooth bit is not bonding grit to the drill bit tooth surface, but rather utilizing an enhanced diamond wear insert. The Company agrees to include in the definition of "Hardfacing Material" the wear inserts incorporated in the cutting structure of milled tooth type bits and any other materials utilizing Megadiamond technology in the cutting structure of any new generation milled tooth type bit.

- d. The "Hardfacing Bearing Material" milestone [Section 3.2(ii)(c)]:

It appears that it may not be economically feasible to develop a main bearing for a premium "journal bearing" type drill bit. The Company agreed but suggested it evaluate the economics of directing efforts to a particular size but for a particular application. The Company would advise of the results of its determination.

The parties agreed that for purposes of Section 3.2(ii)(c)(2) the dollar value calculation to determine when Megadiamond has delivered \$300,000 worth of "Hardfacing Bearing Material" would be the diamond material "value added" by Megadiamond and would not include outside purchases.

- e. The Contribution Margin milestone [Section 3.2(ii)(d)]:

A milestone payment would be due under this section in the year that certain Megadiamond sales exceeded \$5,000,000 with a contribution margin of 53%.

May 11, 1987

Page Four

The definition of sales to be included in this calculation was clarified to mean the exclusion of all sales under previous "TCI enhanced Insert", "Hardfacing Material" and "Hardfacing Bearing Material" milestones and sales of diamond products to Company entities that incorporate such products in drilling equipment.

The Second Indemnity Fund which was established to indemnify the Company for one-half of the license fees paid to General Electric and the attorney fees and costs expended with respect to COGEMA has a balance as of this date of \$280,377. To date, the Company and Megadiamond have paid or are obligated to pay license fees to General Electric of \$500,000 and attorneys fees of COGEMA of \$12,983. The company will therefore withdraw a total of \$262,983 from the Second Indemnity Fund. The remaining portion of the fund, \$17,394, will be included in the money distributed to Shareholders at the time of the distribution of the first milestone payment (estimated in June).

To summarize, the distribution to be made to Shareholders upon satisfaction of the first milestone requirements [Section 3.2(iii)(a)(2)] will be:

"TCI Enhanced Insert" milestone	\$1,850,000
First Indemnity Fund Insufficiency	(398,706)
Second Indemnity Fund Excess	<u>17,394</u>
Total to be Distributed	\$1,476,688

Former Shareholders who have signed and returned the Notification Letter need not sign this letter. Their acceptance of the conditions contained in the Notification Letter is effective for these purposes. Those Former Shareholders who have not signed and returned the Notification Letter should execute the enclosed acceptance copy of this letter and return it to the undersigned in the enclosed envelope.

The Company has been requested by a majority of the Former Shareholders to (i) remove the condition contained in the Notification Letter that the Company's assumption of the Merger Agreement become effective only upon the acceptance of each of the Former Shareholders to the terms in the Notification Letter,

SMITH INTERNATIONAL, INC.

May 11, 1987
Page Five

that is, that the Company assume the obligations imposed by the Merger Agreement with respect to each accepting Former Shareholder even though less than all accept, and (ii) agree that all Former Shareholders be treated the same with respect to distributions under the Merger Agreement.

The Company understands the desire by these Former Shareholders for certainty, but is advised that it should require acceptance by all Former Shareholders to insure itself that it does not have a Merger Agreement that is effective for some but not all of the Former Shareholders. It would not be possible to treat all Former Shareholders the same if not all were subject to the same contract terms. As an accommodation to these Former Shareholders, however, the Company will consider waiving the requirement for unanimous acceptance if acceptance by Former Shareholders representing two-thirds of the equity of Megadiamond is received by May 31, 1987.

Very truly yours,

SMITH INTERNATIONAL, INC.

Ronald R. Randall

Ronald R. Randall
General Counsel, Secretary

Agreed, acknowledged and accepted:

Ida Rose Hall
signed & submitted
5/13/87

RRR/lh
Enclosure
R423871