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January 30, 1981

The Honorable William Marvel
Court of Chancery
Public Building
Wilmington, DE 19801

Re: Smith v. Pritzker, et al.
Civil Action No. 6342

Dear Chancellor Marvel:

It was not until late in the day on Tuesday, January 27, 1981, that defendants received the Affidavit of Milton L. Meigs and the attached report by the firm of Duff & Phelps, Inc. Mr. Meigs' deposition was taken on Wednesday, January 28, 1981, and this supplemental memorandum in letter form is being submitted as a result thereof.

1. Introduction

It should be noted at the outset that Duff & Phelps' report ("D&P" Report) is not the dispassionate analysis which one would expect from an independent appraiser. In fact, it

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more nearly resembles the brief of an advocate than the impartial report of an expert.* Moreover, the opinions expressed are nothing more than the speculation of one who is not called upon to put cash on the line, but merely to develop a report favorable to the party retaining him.** The evidence is uncontroverted that those persons who were called upon to put cash on the line--the companies which the investment banking firm of Salomon Brothers contacted in an effort to find a better bid--refused to pay more than $55 a share for Trans Union. For this reason alone, Duff & Phelps' opinions are unworthy of any serious consideration.

In an effort to explain away the refusal of anyone to bid more for Trans Union than $55 a share, Duff & Phelps speculates that the time was not sufficient to allow another merger

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* E.g., the Duff & Phelps Report argues that the directors were "summoned to a special meeting on September 20, 1980", and were "given to believe that the proposal" would have to be approved before the end of the meeting (D&P Report, p. 4); that "senior management first learned of the merger minutes before the special meeting" (D&P Report, p. 4) (not revealing that the Chairman, the President and the Corporate Controller of Trans Union had been heavily involved in the matter during the week preceding the meeting); that the Trans Union board failed to consult with its own management "much less the Company's investment bankers" (D&P Report, p. 12,); etc. (emphasis supplied).

** Duff & Phelps will be charging plaintiff around $25,000 for its services in this matter (Meigs Dep., p. 28).

partner to be found (D&P Report, pp. 23-24). This speculation is inconsistent with the facts. Jay Higgins, the partner in charge of Salomon Brothers' efforts testified that no prospect indicated that the time needed for response was insufficient (Higgins Dep., p. 131). The Pritzkers themselves entered into a definitive merger agreement in seven days, from September 13 through September 20, 1980. Most striking, however, is that Duff & Phelps reached its conclusions regarding the value of Trans Union's shares in two and one-half weeks (Meigs Dep., p. 6), using essentially available public information about Trans Union and the same internal data made available by Salomon Brothers to prospective merger partners, all of which, of course, was available to the directors of Trans Union on September 20, 1980 when they considered the Pritzker offer (Meigs Dep., pp. 18-20). Since the entities which Salomon Brothers solicited had more than <u>three months</u> to do what Duff & Phelps claims it did in <u>two and one-half weeks</u>, it is obvious that there was ample time in which to make a competing bid.

Duff & Phelps' opinion is suspect for another reason--it was written not only by Duff & Phelps, but also had substantial input from plaintiff's counsel in this litigation (Meigs Dep., pp. 11-13). Meigs, the individual in charge of Duff & Phelps' effort, testified that only the "core issue of

value" was exclusively that of Duff & Phelps (Meigs Dep., p. 10), and that the remaining material was affected by and modified in accordance with counsel's suggestions (Meigs Dep., pp. 9-13). This has enabled counsel to rely upon material which <u>he</u> suggested to Duff & Phelps to support <u>his</u> arguments in Plaintiff's Memorandum (<u>e.g.</u>, pp. 45-46).

Moreover, Duff & Phelps was provided with only a selected portion of the evidence available in this case, and in particular was not provided with the depositions of the outside directors of Trans Union (Meigs Dep., pp. 15, 26), and thus had no basis for determining (1) whether the outside directors believe the $55 a share price to be fair, or (2) whether the outside directors had the benefit of any internal Trans Union studies regarding the value of Trans Union's stock (Meigs Dep., p. 24).* It is obvious, however, that since the directors were advised of Trans Union's internal analyses of the stock's value, and since they also had, as directors, current operating statements, financial reports, and similar information about the

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* A number of the outside directors testified that they were informed of the results of the updated study by Mr. Romans showing that Trans Union stock was worth between $55 and $65 per share. Duff & Phelps never saw a copy of the Romans' report (Meigs Dep., p. 22). Meigs attempted to explain this away by contending that Romans' study did not relate specifically to the Pritzker proposal (Meigs Dep., p. 24), a weak explanation at best.

Company, they could readily determine whether a $55 cash offer was in the range of fairness. Thus, most of Duff & Phelps' report, which does not specifically relate to value, must be ignored. It is tainted not only by counsel's direct participation, but also by a less than impartial selection of the materials provided for review. It is, in short, a "briefidavit".

2. The Discounted Cash Flow Analysis

That portion of the report which appears to have been prepared by Duff & Phelps rather than counsel for plaintiff is also subject to serious flaws. One of the two basic approaches which Duff & Phelps adopted is based upon an estimate of discounted cash flow projected for Trans Union into the indefinite future (D&P Report, pp. 20-21, and Ex. A-2). The starting point for this analysis was an internal Trans Union projection prepared and presented to the Board of Directors on July 17, 1980 (D&P Report, Ex. B).* But the financial projections are, by their own terms, subject to substantial uncertainty which impairs their validity. For example, the projections are explicitly made subject to "the assumptions of

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* Thus, the Board itself had the very projection which formed the basis of Duff & Phelps' analysis. The Board also had the benefit of the study done by The Boston Consulting Group, the details of which were presented to the Board at a meeting held in August, 1980 (Chelberg Dep., p. 20).

economic recovery in 1981 and an annual inflation rate of 9%" (D&P Report, Ex. B, p. 1)--neither of which is probable, let alone certain. Similarly, the projections contain two pages of potential "pitfalls" which would impair the reliability of the projections (D&P Report, Ex. B, pp. 14-15). It is significant that Meigs agreed with the statement in the Trans Union Proxy Statement concerning those projections:

> "...because the Company's projections were based upon significantly lower than current interest rate assumptions and upon the continuance of current federal tax laws, it cannot be regarded as a meaningful prediction of earnings for future periods." (emphasis added).

(PS, p. 3; Meigs Dep., pp. 139-140). It is incredible that, although Duff & Phelps agreed the projections were not "meaningful", it nevertheless made them the basis of its discounted cash flow analysis.

Indeed, because cash flow projections are so inherently uncertain, Delaware law precludes their use in determining fair values. Frick v. American President Lines, Ltd., Del.Ch., C.A. No. 3766 (unreported opinion, a copy of which is attached hereto as Annex A). As this Court held in that case:

> "The accounting technique known as cash flow analysis seeks to utilize presently available information so as to project future income flow to the corporation. However, mere projections of future earnings have been looked

upon with disfavor in Delaware as speculative. See Levin v. Midland-Ross Corp., Del.Ch., 194 A.2d 50, 57 (1963), Cottrell v. Pawcatuck, Del.Supr.Ct., 128 A.2d 225, 231 (1956) and David J. Greene & Co. v. Dunhill International, Inc. Del.Ch. 249 A.2d 427, 433 (1968).

"Thus, the cash flow technique sought to be invoked here is, in my opinion, overly speculative for the same reasons, i.e. that it rests upon events which have not been shown to be reasonably probable of happening. See Olson v. United States, 292 U.S. 246, 257 (1934). Compare Korf v. Fleming, Iowa Supr. Ct., 32 N.W. 2d 85, 96 (1948), and Brooklyn Eastern Dist. Terminal v. City of New York, 139 F.2d 1007, 1013 (2d Cir)(1944) cert. den., 322 U.S. 747.

"Furthermore, it is apparent that the cash flow analysis is limited in its usefulness as a projection by the very fact that its validity rests upon the financial techniques of a few experts. Accordingly, when the Delaware courts have been confronted with the task of ascertaining the effect of future prospects on the present value of a stock in the absence of an open market, they have turned their attention to aggregate figures. Thus, the capitalization rate for a company is often determined by compiling a weighted price-earnings ratio from a study of the open market price of shares by comparable businesses in the same or similar industry. This figure, which is, in effect, an open market estimation of the future prospects of such business, negatives the factor of individual speculation. This ratio is then applied to the past earnings record of the subject company to determine the market price that the company could reasonably expect to obtain." (emphasis added). Annex A, pp. 8-9.

The weakness of using projections in this case is even more striking, because the principal element of the analysis is what Duff & Phelps describes as the "terminal value" of Trans Union's projected cash flow (D&P Report, p. A2).* This terminal value, however, was obtained by projecting the estimated 1985 cash flow into <u>infinity</u> (Meigs Dep., pp. 111-112). This is speculation of the rankest sort, and is utterly inconsistent with the strict standards under Delaware law for establishing valuation.

The alternative cash flow analysis (see D&P Report, p. 21) is equally flawed. Duff & Phelps assumed that Trans Union's "discretionary cash flow" would continue at 1980 levels forever, and calculated a discounted cash flow on that basis. Since this approach still makes wholly speculative assumptions about the future of Trans Union, it shares all the flaws of the analysis based on the so-called "terminal value" of the cash flow in 1985. In addition, it is curious that the discount factor applied by Duff & Phelps in its alternative calculation is 9%, compared with the 14% applied in its first discounted cash flow

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* The present value of the "discretionary cash flow" for the 1981-1985 period is estimated by Duff & Phelps as $849.4 million; of this, the terminal value represents $665.5 million.

analysis (D&P Report, pp. 20, 21).* The "explanation" given for this deviation is that a company which experiences cash flow growth of 20% a year is riskier, and hence merits a higher discount rate than a company whose earnings are stable (Meigs Dep., pp. 113-116). This conclusion is totally illogical, as it values thriving companies on a worse basis than stagnant concerns, and accordingly destroys any credibility in this part of the Duff & Phelps' analysis. Moreover, since the market was discounting the stock at about 14% (in early 1980, a stockholder was paying approximately $35 per share in the face of 1979 earnings per share from continuing operations of $5.01, a return of about 14.5%), Duff & Phelps' choice of a 9% discount factor is indefensible. If a 14% discount factor, rather than 9%, had been applied by Duff & Phelps, the per share "value" would be about $45 rather than the $69.71 suggested by Duff & Phelps.

3. Comparative Analysis

The second approach followed by Duff & Phelps fares no better. The basic methodology consisted of examining various

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* Duff & Phelps was also remarkably cavalier in its explanation of which discount rate was appropriate. When it was suggested that the 9% inflation component included in the 14% discount rate was too low in light of existing inflation expectations, Meigs replied that he would simply lower the component relating to the real interest rate from 3% to 1% in order to compensate (Meigs Dep., pp. 132-133). This suggests that Duff & Phelps was more concerned with reaching a particular result than utilizing correct methodology.

takeover and merger bids made in the marketplace between February 26, 1979 and September 20, 1980 and applying the median of the premiums paid over the unaffected market price, and the median of the price/earnings ratios paid, to the proposed merger. (D&P Report, pp. 16-18 and A-3). The basic thrust of this analysis is that the "fair" price for Trans Union in this case is one which reflects the median premium over market and the median price/earnings ratio paid in other acquisitions. The entire basis for this analysis is vitiated, however, by Meigs' testimony that he could not say that a merger at less than the median premium or price/earnings ratio was unfair. (Meigs Dep., pp. 90-91, 96). His admission is, of course, obvious in view of the fact that each transaction must stand on its own. Thus, this analysis is of virtually no utility as a valuation tool.

There are other flaws which appear in the analysis of other acquisitions. For example, the list of transactions used to develop the median premiums and price/earnings ratios includes transactions in which there was a takeover contest between competing offerors (Meigs Dep., pp. 81-86), as well as transactions in which the takeover attempt may have been hostile rather than friendly. Each of these facts would be likely to increase the amount ultimately paid in the acquisition, and indeed, Meigs so admitted with respect to contested takeovers

(Meigs, Dep., p. 86). In short, this aspect of the Duff & Phelps report is of no greater weight than the discounted cash flow analyses referred to in Section 2. above.

4. Conclusion

For all these reasons, the methodology of the Duff & Phelps report is erroneous, and the conclusions reached are unworthy of credence. It is apparent, moreover, that the entire report is no more than sterile musings in an ivory tower, which are entitled to no weight when compared with the actual crucible of the market place which showed that no one was willing to bid more than $55 per share for Trans Union. Indeed, the irrelevance of the Duff & Phelps study is highlighted by Meigs' inability to estimate the effect on Trans Union's stock price if the merger were enjoined (Meigs Dep., p. 147), and his grossly erroneous prediction based on nine month figures that the Company's earnings per share in 1980 would be around $5.45 to $5.50 (Meigs Dep., p. 45). In fact, the 1980 earnings per share were only $4.87 (SPS, p. 5), almost 13% lower than Meigs predicted.

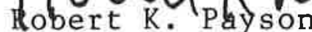
Apparently unknown to Meigs, Duff & Phelps conducted a previous study for Trans Union in 1978 in connection with the issuance of certain restricted stock as part of a Trans Union acquisition (Meigs Dep., Ex. 6). In that study, Duff & Phelps

estimated that the market would tend to assign a low value to Trans Union's securities:

> "We are of the opinion that Trans Union's market performance over the next several years will continue to reflect the market volitility and the past cautious attitude of the investment community toward the company. Based on the historical pattern it appears that an area of price support for Tans Union common shares could be found in thr low twenties, based mainly on the stability and growth potential of the company's dividend." (emphasis supplied). (Meigs Dep., Ex. 6, p. 4).

The conclusion of this analysis is clear notwithstanding subsequent affidavits from Meigs and one of his associates at Duff & Phelps which attempt to explain away their earlier report. Short of the rankest speculation, there is no prospect that Trans Union shareholders will receive more than $55 per share for their stock in the foreseeable future. After an extensive search by Salomon Brothers, no higher bidder has been found. The free market, and not the opinion of plaintiff's expert, has established without question that the $55 per share offer is reasonable, and that the shareholders of Trans Union should be permitted to determine if they want it.

Respectfully yours,



Robert K. Payson

RKP/wpc

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