

January 08, 2009

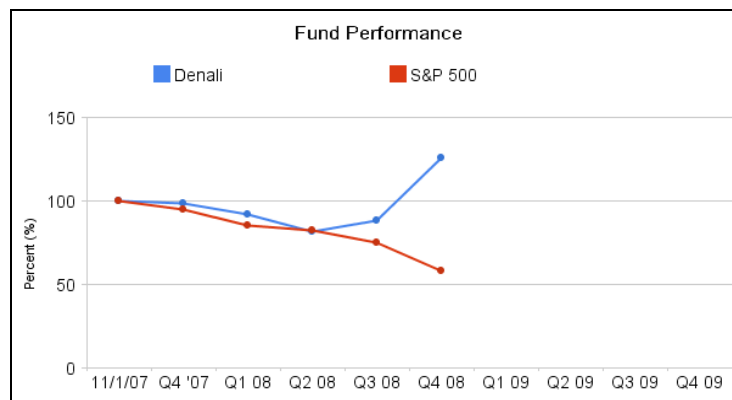
To: All Limited Partners
Re: Fourth Quarter 2008, Letter to Partners

Dear Partners:

Please find below material information regarding Denali Investors funds.

Performance

For Q4 2008, Denali Investors funds returned +42.9% and the S&P 500 returned -22.6%. For the year 2008, the funds returned +28.0% and the S&P 500 returned -38.5%. Since inception, funds returned +25.8% and the S&P 500 returned -41.7%.



General Comments

For over a year, we have been waiting for Mr. Market to have a major sale. This quarter, he did not disappoint. October and the year of 2008 were historic on many levels and take their place among the most significant and dubious periods in financial history.

We are in a period in which forced sellers find themselves in a position in which 1) underlying value is not a concern and 2) selling is forced by withdrawals and redemptions, and 3) prices are crushed. This is a necessary, albeit painful, part of a boom-bust cycle and allows the system to clear out previous excesses. It should be considered a net positive development that people in aggregate are undergoing a shift from 'buying things you don't need with money you don't have' to 'buying things

you do need with money you do have.’ Yet current intervention efforts attempt to prevent this transition from the former to the latter when it should be clear that the former is the unsustainable problem.

Put another way, 2008 was the year of Disorderly Deleveraging. If such disorderly deleveraging was a symptom, then the disease itself was Orderly Leveraging, which grew unchecked during the decade before. Curiously, very few attempted to moderate an unsustainable orderly leveraging bubble (the root of the problem), but almost everyone is now attempting to prevent a valid disorderly deleveraging (the natural consequence).

In trying to sustain the unsustainable, the government’s prescription for the economy’s debilitating hangover is simply to supply more alcohol. This will likely not end well. In order to avert a systemic collapse (caused by unchecked orderly leveraging), the 0% interest rates and trillions of dollars in bailout and stimulus are enabled by politically expediency. These moves are largely unprecedented and unsustainable, but not irrational. Unfortunately, by taking these steps, the seeds for even greater problems down the line are being sown.

The current government intervention has increased my concern with respect to longer term inflationary pressures on the U.S. dollar. I am not an expert regarding macroeconomic forces. However, there exists a material chance that the value of our dollars will be eroded away in the coming years by inflationary policies. What this means is that to protect our dollar-based purchasing power, we will need to be running ahead just to stay in the same place. The irony is that the higher inflation resulting from intervention, which was intended to help, actually harms those that are the most vulnerable (e.g. minimum wage is not pegged to inflation).

The standard advice being given out is for investors to be conservative. However, rather than actually being conservative, what is disguised as conservative is in reality just conventional. Treasuries at 0% are not conservative. 30-year governments below 3% are not conservative. TIPS bonds are not conservative (they will not pay you a real inflation premium). Unfortunately, these conventional investments may do nothing to maintain or increase purchasing power and in fact will likely result in losses of real value. In the same vein that confuses conservative with conventional, deflation is not the same as lower prices just as inflation is not the same as higher prices. These are critical differences that most choose to accept as equivalents.

So how is our fund positioned?

Given the significant market sell off, we were quite active during the quarter. Q4 did not include any new strategies, despite any lumpy performance on a quarterly basis. We simply continued to pick ideas we considered worthwhile.

Our investments consisted of a variety of special situation opportunities such as spin-offs, tender offers, and mergers. Certain opportunities were priced at levels not seen in decades. Simply by having cash available to put to work, we were able to participate in a meaningful fashion. To our

benefit, the outcomes of these catalyst-driven investments worked in our favor very quickly and drove the bulk of the performance for the quarter. As it stands, the invested portion of the fund remains net long and consists of a handful of our favorite ideas.

Investment Updates

This section provides an update on our special situation investments.

Special situations include misunderstood and mispriced companies, spin-offs, restructurings, bankruptcies, distressed securities, distressed bonds, merger arbitrage, etc.

The advantage of allocating capital to these special situations is two fold:

- 1) The risk reward ratio can be highly favorable. In many cases, a special situation unlocks pre-existing value that has been embedded or ignored by the market.
- 2) The unlocking of value is not correlated to the stock market, but rather through company level actions and outcomes.

In this section, you will notice that I have included the verbatim commentary from previous quarters. I believe the inclusion, with content unchanged, is helpful in that it keeps the thought process in the open and provides a handy reference throughout lifecycle of our investments. You may note that the section is getting longer with each passing quarter by virtue of the quarterly update. You can set aside your concerns of deforestation each time the letter arrives given our special situation investments tend toward having definable timeframes and therefore, we hope, will be replaced with equally attractive opportunities.

Investing in these special situations goes back to the core of our investment framework. This is especially relevant in the current environment, one in which many are concerned about subprime and recession. These examples should help demonstrate that Denali's results will be determined by the outcome of these individual opportunities, not the noise in the overall stock market. Ironically, it is more like gambling, and less like investing, to put money blindly into broader indexes. Again, it is not the short term performance of the stock market or the fund that matters to us.

The only reason Denali was started was to provide absolute returns and beat the market over the long term. I believe these types of investments position us very well to do just that.

Special Situation 2: Value Activist

From Q4 2007: In this situation, the Company (Co) is trading at a price that is far below its intrinsic value. Co is at \$10 per share. There are three main drivers of embedded value in this situation. 1) Given an incredibly valuable real estate portfolio, there is about \$10 per share in real

estate value available for sale-leaseback. 2) The company owns almost all company units and can refinance the majority for \$10 – 15 per share. The residual royalties for just the refinancing alone are worth about \$0.50 per year, or say \$5 in conservative present value. 3) Operations are substandard and have much room for improvement. The changes that will take place at the operating level are of material importance and will be led by a highly successful team (not the previous management team). Incremental margin expansion creates additional value, but let's assume this results in \$0 value if not successful to \$5 if there is some value created. The combined results unlock and create value in the range of \$20 – 35 per share.

UPDATE (Q1 2008): The proxy contest was successful, and two Board seats were won. I have been engaged in a productive dialogue with the Board and the probability shareholder friendly steps will be made this year is favorable. However, in the interim, the share price has traded down with the sector, which is less a concern and more an opportunity.

UPDATE (Q2 2008): The shareholder base became increasingly overt in its disenchantment with the incumbent board and management team. In a surprising and fortunate turn of events, during the quarter the value activist was appointed as Chairman, the implications of which are tremendous. Importantly, cash flow is still strong, capex is under control, and the original investment thesis is more valid now than before. Not surprisingly, the market has given no credit for these developments, and I believe the disconnect offers us a wonderful opportunity to acquire more shares.

UPDATE (Q3 2008): The Company is taking the right steps ahead of the expected timeframe. These include management changes, expense reduction, product rationalization, expansion capex reduction, unit closings, sale leasebacks, and debt reduction. In addition, I expect debt to be fully paid down in six months and a subsequent initiation of share buybacks that will further increase per share value.

UPDATE (Q4 2008): The Company is continuing to take the right steps ahead of schedule. Insider purchases continued during the quarter.

Special Situation 4: Negative Stub Pair Trade

From Q4 2007: In this situation, the Parent Co. (PCo) trades at \$10 per share. PCo, however, owns \$20 per share in a majority controlled and publicly traded subsidiary, SCo. If we assume PCo (ex SCo value) is worth absolutely nothing, this implies PCo stock, due to SCo value, is worth \$20! In order to unlock value, management is pursuing a sale of its largest PCo segment, which has been losing money. The chairman owns a very large stake in the PCo and has recently revealed a very large stake in the SCo. My sense is that the SCo stake was taken to maintain control in the event of a spinout of SCo. The unfolding of these events will unlock the tremendous embedded value in PCo. As such, we are long PCo and short SCo in order to earn the collapsing spread.

UPDATE (Q1 2008): The PCo did sell its large, money losing division during the quarter. Once the market understands the forward metrics versus the rear-view mirror database numbers, the

spread should collapse further. In addition, a tax-free spin out would be a tremendous catalyst. During the quarter, we took a net long position in PCo.

UPDATE (Q2 2008): This remains a compelling opportunity. As it stands, the PCo is now a wonderful business masked by a not so wonderful business. I believe the value spread will collapse with time or a spin out will force unlocking of value.

UPDATE (Q3 2008): The thesis has not changed since our initial position. However, the stock price remains rather active. We have been able to take advantage of the price movements around our core position with comfort given that the underlying value of each share is over twice the market price.

UPDATE (Q4 2008): We unwound this position during the quarter. The position was especially volatile during the quarter and it seemed prudent to close the position while the market offered us an attractive price. I hope to reestablish this position if the pricing reverts back.

Special Situation 5: Buy One, Get Three Free

From Q1 2008: In this situation, the Company trades at \$10 per share and has two businesses that contribute similarly to cash flow. At the current price, 1) the first business is at half price, 2) the second business is free, and 3) liquidation value for the combined company is a double. So in a worst case scenario, one gets a double on the investment. Also, if an event, which has a material chance of occurring, actually does occur, the remaining business is then created at a negative enterprise value. To be clear, this means we would be paid (not pay) to take the business, which happens to be a consistent, profitable business at that.

UPDATE (Q2 2008): This was our worst performing position and explains the bulk of our performance for the quarter. During the second quarter, the Company experienced a material adverse event in their first business. However, the market has severely overreacted. The market is giving no credit for the second business and also is assigning a valuation that is a fraction of total liquidation value, if we experience a worst case scenario. The first business will likely be unwound at negligible cost to the Company, another aspect the market is not recognizing. Once the dust settles, the conservative upside is 5x to 8x the current price. We purchased more.

UPDATE (Q3 2008): There have been positive developments since last quarter in that the unwinding of the first business is taking place in an orderly manner. Moreover, in the unwinding, major items on the financial statements will unwind at no cost, and even a cash inflow, to the Company. The market has misinterpreted certain headline news with the reality of the business. Once there is clarity from upcoming announcements, the market will realize the current disconnect from underlying value.

UPDATE (Q4 2008): The Company is winding down one segment while the remaining segments have a conservative valuation at multiples the current price. Insider purchases and additional purchases from large shareholders have jumped.

Special Situations for Q4 2008:

We were quite active during the quarter and participated in a handful of special situation investments. Generally, we were not going for homeruns and simply wanted to avoid striking out. The tactical approach was to play small ball, which is to say we were looking to put ourselves in a position to score runs via bunts and aggressive base running.

With the goal of avoiding major strikeouts, we were able to concentrate on grossly mispriced opportunities such as spin-offs, tender offers, and mergers with highly favorable risk-reward ratios. The outcomes were largely favorable to us. These types of special situation opportunities have proven, and will likely continue to prove, valuable to the fund.

Archived Special Situations

- #1: Spin-Out [A]
- #3: Restructuring
- #6: Heads We Win, Tails We Don't Lose

A Special Thanks to Our Investors

Denali Investors is fortunate to 1) be extremely selective in the manner we make investments, and 2) have partners with a long-term value perspective in combination with outstanding professional and personal character. The firm is lucky, and rare, in this regard.

One of the most important differences is that our investor base understands that a stock at a 75% discount to intrinsic value can change to a 70% or 80% discount, simply due to short-term noise. The short-term 20% move from the entry point is understood as largely meaningless and that the eventual realization of intrinsic value is our focus.

It is a true pleasure to go to work everyday on your behalf.

I thank you for your trust and support. And thank you for the referrals!

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Next Opening: February 1, 2009

Openings for both the Accredited and Offshore Fund are on a monthly basis and for the current quarter is February 1, March 1, and April 1.

Existing partners of either fund can add assets in increments of \$50,000 at each opening.

The minimum initial investment for DIAF is \$100,000. To invest in the fund one must be an accredited investor as defined by the SEC. Openings are on the 1st of each month.

The minimum initial investment for the DIOL is \$100,000. To invest in the Offshore Fund, one must be a non-US accredited offshore investor or tax-exempt account such as IRAs. Openings are on the 1st of each month.

Please note that all new assets received are subject to the two-year lockup period. Funds received by February 1, 2009, for example, will be open for redemption on February 1, 2011.

Miscellaneous

In terms of housekeeping, we have moved operations to 1560 Broadway. I am pleased to share that the office space is 1) 10% lower in price but yet, 2) 50% bigger in square footage. Please feel free to visit if you are in the midtown area.

I have posted letters and documents to the site so that you may refer to them at your discretion.

Your K-1's will be processed and mailed by our auditors soon.

As mentioned, should you have any questions or follow up, please feel free to contact me anytime at (646) 964-5355 or kbyun@denaliinvestors.com.

Respectfully,



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