

April 07, 2009

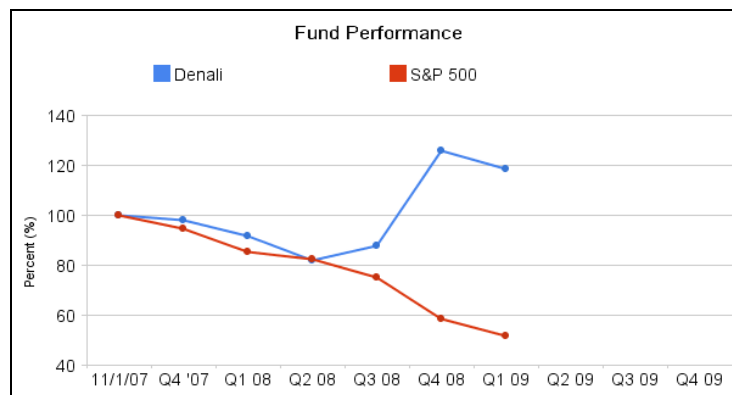
**To:** All Limited Partners  
**Re:** First Quarter 2009, Letter to Partners

Dear Partners:

Please find below material information regarding Denali Investors funds.

### Performance

For Q1 2009, Denali Investors funds returned -5.6% and the S&P 500 returned -11.7%. Since inception, Denali Investors funds returned +18.7% and the S&P 500 returned -48.5%.



### General Comments

In general, the start of 2009 has been predominately marked by continued fear and dislocation. Similar to a euphoric bubble, valuation takes a back seat in the general market participant's thinking. It's shoot first and ask questions later. In the current bearish environment, market participants are not inclined to bother with parsing out whether impairment is permanent or temporary, whether it is real or perceived. The sharp discounts we see in stores all across the country have a mirror image in the stock market. However, while people seem to clamor for the steep discounts in stores, somewhat confusingly they fear even better discounts in the stock market.

The market continues to demonstrate manic depressive qualities in earnest. During the first quarter, the S&P 500 Index was down over 25% at one point before rallying to end down almost 12%. Like

a reveler at the St. Patrick's Day parade near my office, the market was trying to go somewhere but progress was erratic and lurching. In terms of any forward progress, i.e. the recent rally in the markets, it seems to be based on false hope such as the FASB relaxing mark-to-market rules that may be circumspect at best and ultimately destabilizing at worst.

### Potential Energy

*“Most of my mistakes came from when the position was changing character... In chess very often there's the building of tension. You have a very complex position and it's abstract still. There's all this potential energy in the air but there's nothing kinetic happening yet. And it's building and building. And then you have this moment when it goes from the abstract to the concrete, where the positional becomes very tactical... when you move from the positional to the tactical or from the tactical to taking a deep breath and going back to deep strategic thinking. My mistakes were all happening in a moment of transition when the character of the game was shifting.”*

- Josh Waitzkin, International Chess Master

After a thorough self review of a series of painful losses, Waitzkin discovered a repetitive theme of error in his play which is described above. In my view, this theme describes quite closely the cascading series of events that have unfolded in the markets since October 2007. The transition from a building potential energy to an active kinetic energy is difficult to recognize and even more difficult to operate within. Most participants mistakenly saw the previous bull market as kinetic energy, given rising prices and a commensurate rising level of excitement. However, as on the chess board, it was actually a building of potential energy – a globally synchronized boom/bubble in the markets. In hindsight, we know October 2007 marked the switch from market potential energy to kinetic energy, with powerful forces unleashed in a vicious cycle.

So while the turmoil has rendered many market participants unable to act, we must remain ready. As assets are priced further and further down, potential energy is once again building, but this time a constructive one in which the margin of safety for select investments will reward those that are able to act accordingly and execute efficiently. To our benefit, the constructive potential energy inherent in value-based investments lends itself to prices moving upward to better reflect intrinsic value.

As the forced selling and non-fundamental volatility continues, an increasing set of worthwhile opportunities emerges. And opportunities, as they say, multiply as they are seized. This concept relates directly to Seth Klarman's point that the ability to fully consider and execute the worthwhile investments of today is enabled by the worthiness of investments past. Notably, fund managers that scramble to quickly make up for lost ground may stretch in process and portfolio composition in an effort to recoup losses. Not only is that mindset disadvantageous and dangerous, more importantly it runs counter to the overarching commandment of capital preservation. In taking this path, fund managers may turn an honest mistake into a dishonest one. It is critical, regardless of recent performance or legacy positions, that we maintain a steady temperament, consistent research process, and clear thinking about the current opportunity set before us.

## **Our Investment Framework**

Based on the recent and continuing upheaval in the markets, it becomes worthwhile to revisit the fundamentals of our investment framework and to reevaluate the manner in which they hold us in good stead through current and future turbulent times. Although our partners already adhere to our investment mindset and believe in the validity of the tenets (which we consider sensible and logical), we know that most managed capital does not align with our framework.

Our basic structure (the allocation groupings and the incentive structure) is based on the Buffett partnerships from the 1950's. Today, most people associate Buffett with a buy-and-hold-forever philosophy. However, most people do not know how he first created wealth for his investors and himself. What the popular view discounts is that Buffett began his career managing a hedge fund that was value-based and heavily involved in special situations. Basically falling into two categories, his "Generals" were undervalued stocks (still studied by many today) and his "Workouts" were special situations investments (forgotten by many more).

Generals & Workouts: The Generals tend to produce returns that are more greatly affected by the overall market performance, as with rising or falling tides. The Workouts tend to provide market agnostic returns and tend to have more attractive risk-reward profiles in downturns. Much of Buffett's consistency in outperformance even during years in which the markets declined is attributable to his special situation investments. Critically, the combination of the two is much more powerful than either one alone in producing absolute returns over an extended time frame.

The validity of this portfolio structure strikes me as powerful, simple, and elegant. In my view, those that focus only on one category at the exclusion of the other are at a fundamental disadvantage. The inherent balance in the combined structure is why Buffett himself said he expected, although could not guarantee, to outperform in bear markets and underperform in bull markets. By having a balanced tool kit, a portfolio remains flexible in allocating to the most promising opportunity set that presents itself.

Flexible mandate: We have a flexible mandate that allows us to look at any opportunities that may be attractive. Certain funds that are designed to fit into a 'style box' mean captivity to a certain sector, geography or asset class. The problem for the fund manager is that capital can flood out as easily as it floods in (i.e. technology sector funds in 1999 versus 2000 or energy specific funds in 2008 versus 2009). Also, they become captive to a slice of the market when it is no longer attractive and simultaneously prevented from areas that are attractive. Whether bargains are available or not is immaterial. The order of the day is to sell. As a generalist, our flexible mandate allows us to look at opportunities across the spectrum.

Concentration: Another advantage is our concentration of investments into our best five to ten investment ideas. Our opportunistic style of investing allows us to wait for investments with highly favorable risk-reward profiles and requisite margins of safety. Allocating more capital to really good

ideas, which do not come around too often, simply makes sense. This builds a portfolio one idea at a time, such that performance over time correlates to the outcome of those ideas rather than to the market. On the flip side, the typical mutual fund holds about 80 positions, which practically guarantees below average performance and explains why 80% of them under perform the market simply due to frictional costs.

Cash: Another advantage is the ability to maintain net cash in the absence of other opportunities. Many funds must be fully invested according to the fund's mandate. A fund manager must then perhaps buy at a time that may not be prudent or sell at a time that is even less prudent. Our ability to hold cash is a great advantage, especially as the current market dislocation unfolds. The use of leverage can be extremely dangerous. As has become apparent, investments that were mediocre at best were made to look superior in cooperative markets through the use of easy borrowing.

Alignment of Interests: We eat our own cooking. I have the lion's share of net worth in the fund and I will continue to keep my assets in the fund. The idea is if we do well, we all do well together. I can assure you that my focus is on judiciously growing partners' capital. The fund manager, whose responsibility is to protect and shepherd capital, should not be exempt from the downside risk. One should cast a very skeptical eye at managers that consistently pull their fees out of the funds they manage.

### **So how is our fund positioned?**

Currently, one area of particular interest is capital structure arbitrage. Share spreads between common classes are at historic levels. Spreads between common and preferreds are also at historic levels. Consistent with last year, the merger arbitrage area continues to provide interesting opportunities. Another area of research is in corporate liquidations, the idea being that some companies are better off dead than alive. From the pool of potential liquidations, the opportunity lies in the eventual recovery value and the time required for return of capital, which are subject to various risks.

Unlike 2008, there are fewer interesting partial self-tender offers today, which is a function of management teams wanting to preserve cash. However, there appears to be instead an increased interest in self-tendering for debt at a discount (an understandable shift). Longer term, as a consequence of the current environment, there will be interesting opportunities that arise from the upcoming bankruptcy wave. As companies restructure, in doing so they will create exit structures for which various tranches of value will fall into hands of rather unwilling and unnatural holders, creating for us an incredible opportunity set.

With the focus on capital preservation, I believe our patience will be rewarded with actionable bargains with highly skewed risk-reward profiles. We will simply continue to pick ideas we consider worthwhile.

## 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 rebrand the majority for \$10 – 15 per share. The residual royalties for just the rebranding 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.*

*UPDATE (Q1 2009): The Company continues to take the right steps and has exceeded expectations in its turnaround process.*

### **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 unbound 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.*

*UPDATE (Q1 2009): We exited this position in the quarter as the price reached our target price.*

#### **Special Situations for Q1 2009:**

We were relatively quiet during the quarter despite a great deal of research and effort. Starting the quarter, I expected many more actionable ideas, which ended up not being the case, despite the continued decline in the indices. However, many interesting opportunities presented themselves at the end of the first quarter, some of which may become positions.

#### **Archived Special Situations**

- #1: Spin-Out [A]
- #3: Restructuring
- #4: Negative Stub Pair Trade
- #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.

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

**Next Opening: July 1, 2009**

Openings for both the Accredited and Offshore Fund are on a quarterly basis. 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 1<sup>st</sup> of each quarter.

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 1<sup>st</sup> of each quarter.

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

**Miscellaneous**

In terms of housekeeping, we have settled comfortably into the new office space. 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 convenience.

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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