DENALI INVESTORS, LLC

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April 6, 2010

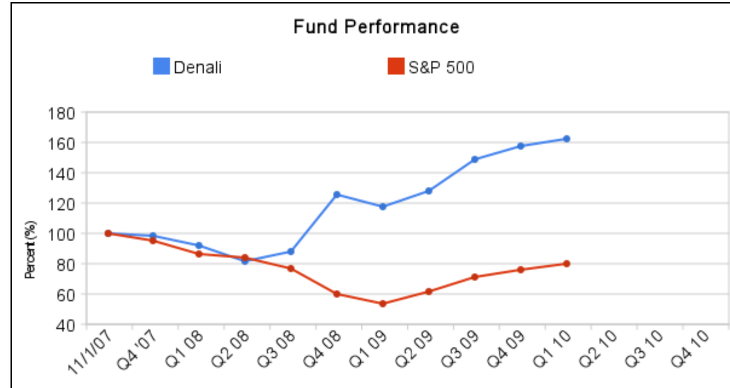
To: All Limited Partners
Re: First Quarter 2010, Letter to Partners

Dear Partners:

Please find below material information regarding Denali Investors funds.

PERFORMANCE

For Q1 2010, Denali Investors funds returned +3.0% and the S&P Index returned +5.4%. Since inception, Denali Investors funds returned +62.5% and the S&P Index returned –20.1%.



GENERAL COMMENTS

The first quarter of 2010 has been marked by a continued upward creep in the markets, in stark contrast to recent fear and dislocation. From the lows reached far back in March, when the S&P broke to 667, we have seen a rally of over 75%.

2010, as it turns out, is a make-or-break year for many funds. The severe drawdown in 2008 and massive run-up in 2009 showed once again that it is better to fail conventionally than to succeed unconventionally. With many funds still below high water marks, their urgency for near-term

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performance in 2010 is greatly magnified. How can these fund managers properly invest with a long-term view when a short-term sword of Damocles hangs precariously above? Can these Mr. Magoo pretenders make it another year? And so career risk, business risk, and behavioral finance, rather than the best interests of their investors, comes to the fore.

With 2010 shaping up to be another interesting year, my view remains that the potential big-picture range and probability of outcomes have widened considerably, although the expected value or average represented through the market may appear narrow. With all the dislocations, machinations, and interventions, the potential energy in the markets is building once again. Exactly how and when the kinetic shifts occur remain an unknown, but the set up to dramatic changes appears to be in place. Expect the water to be choppy.

One related area that has become a topic of increasing attention, just to pick one out of the hat, is that of exchange rates, namely the call coming from some corners for China to let their currency float. From my perspective, it is not analytically prudent to draw a line in the sand on the issue due to the tricky and ever present law of unintended consequences. There are many interpretations even for concepts far simpler than floating and fixed rate frameworks, but let's venture through. Regarding these unintended consequences, I would like to humbly present the following words as food for thought.

I often see politicians on the news putting the issue in binary terms, as right versus wrong, as good versus bad, as us versus them. This may prove to be a great disservice. Indeed, our country has outsourced many jobs, and low level ones at that. But this means we have also outsourced our unemployment and social unrest. Can you imagine what our unemployment number would look like if the capital base and employee base that supplies our goods just from China were simply put inside the US? Would it surprise you that this would approach Great Depression numbers? The migrant workers and unemployed masses of the Great Depression actually do exist today. But it simply goes unnoticed here because that too has been outsourced!

Conversely, what I have never seen a politician ever mention in the exchange rate debate is the likely resulting inflation. Why not? The average person is already stretched and living paycheck to paycheck. The group that will be impacted the most, which is that same group to which politicians pander, will find costs for basic items moving further out of range. Does it make sense that twenty pairs of tube socks from China are available for $8 retail? For every dollar prices for these tube socks move up to reflect true domestic and rate adjusted costs, a dollar less is available for other necessities. Such limited financial resources create an increasingly desperate zero sum game. Do I buy food or do I buy school supplies for the kids? If exchange rates do float and there is inflation, what will be the call to action then? Who will be the scapegoat? This may result in further finger pointing and a resurgence of social unrest, trade tariffs, trade barriers, and protectionism. This will be part of a negative reflexive process that may have much more severe and unfortunate consequences. But no one is talking about that.

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If you are intellectually honest, you have to admit this is not a simple scenario to figure out for which this discussion barely scratches the surface and does not do justice.

As such, I present the following parable not as an answer, but as a surprisingly liberating approach for the analytical mind. It is a story my father told me a long time ago.

"Seh-Ong Ji Ma"
(Seh-Ong's Wise Horse)

> There was a farmer named Seh-Ong that had a beautiful and strong horse. The neighbors complimented, "You are so lucky to have such a beautiful and strong horse." The farmer replied, "We'll see."
>
> Days later, the horse ran away from the farm and could not be found. The neighbors wailed, "You are so unlucky to have lost such a beautiful and strong horse." The farmer replied, "We'll see."
>
> Days later, the farmer's horse returned, but had brought back seven other wild horses that were equally beautiful and strong. The neighbors complimented, "You are so lucky to have so many beautiful and strong horses." The farmer replied, "We'll see."
>
> Days later, the farmer's son was attempting to train one of the wild horses, fell off the horse, and broke his leg. The neighbors wailed, "You are so unlucky to have your son break his leg." The farmer replied, "We'll see."
>
> Days later, the king's army came through to take all the able-bodied young men for war. The neighbors complimented, "You are so lucky to have your son spared from the war."
>
> The farmer replied, "We'll see."

For me, this is one of the most powerful, simple, and elegant lessons of life and, therefore, investing.

As we consider our opportunity set, one of the most important factors remains investor psychology/behavior. The investment fishbowl that we inhabit contains limited examples of behavior to emulate but many more of what to avoid. Recent market stress has revealed more than investors realize about their true temperament. With many burned quite badly in 2008, they are hoping against hope that a healing process will result in full recovery of assets, despite lingering emotional damage from broken promises and misplaced trust. These once trusting investors are looking for answers, solutions, and peace of mind. Not without irony, they are seeking ever more

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certainty in an increasingly uncertain world, rather than trying to understand and manage the uncertainty that is inherent in it.

The market gyrations and machinations of 2007, 2008, and 2009 rendered many market participants unable to think and act clearly. With the recent upswing that seemingly provides calm and reassurance, many of the fallen have miraculously, and likely temporarily, been "restored" to dubious honor. Regardless of the market, we must maintain a stable internal compass, and make full use of our practical sensibilities. It is critical, regardless of our recent performance or legacy positions, that we maintain a steady temperament, consistent research process, and clear thinking about the current opportunity set before us.

Given the erratic nature of the market, I remain optimistic about our opportunity set. The uncertainty and dislocation are a blessing to value investors, not because we enjoy uncertainty or dislocation, but because of the opportunities they create. Our strategy has remained consistent throughout and I am selectively employing our flexible and tactical approach congruent with our investment framework.

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 (unstudied by almost all).

Generals + Workouts: The Generals (Long/Short) tend to produce returns that are more greatly affected by the overall market performance, as with rising or falling tides. The Workouts (Special Situations) 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.

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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 & Opportunistic 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' remain captive to a certain sector, geography or asset class. The problem for such fund managers 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 are 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: We are highly selective. Our concentration of investments into our best five to ten investment ideas is an advantage. 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 underperform the market simply due to frictional costs.

Net Cash = Fortress: 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.

Scalability: Our investment ideas are scalable and can be of any market capitalization in any industry. We are not restricted to any particular slice of the market and we view scalability more as a function of the opportunity set provided by the market. Of note, a favorite idea for 2009 was the $12 Billion market capitalization Cardinal Health (CAH) spinoff of CareFusion (CFN). A favorite idea for 2008 was the $1.5 Billion market capitalization Grey Wolf (GW) merger with Precision Drilling (PDS).

Alignment of Interests: We eat our own cooking. I have the lion's share of my 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

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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 who consistently pull their fees out of the funds they manage.

SO HOW IS OUR FUND POSITIONED?

We were very active during the quarter through a great deal of research and effort. Although a market correction was on my wish list and would have been a welcome holiday gift, unfortunately it was not to be. Starting 2010, I did not expect many actionable ideas given the increase in the indices during 2009. However, despite the market run up, a few interesting opportunities presented themselves during the quarter and are discussed below. That said, our backlog of ideas is growing and I hope to put additional capital to work in 2010 in a number of promising areas.

One area of particular focus in which we have participated with success is spinoff opportunities. The pipeline of planned spinoffs for 2010 appears quite attractive and we have put a significant amount of research into these prospects.

There are fewer interesting partial self-tender offers today, which is a function of management teams wanting to preserve cash. However, there remain some of these opportunities and is instead an increased interest in self-tendering for debt at a discount.

Another area of activity for us is in corporate liquidations, the idea being that some companies provide greater value dead than alive. From the pool of potential liquidations, the opportunity lies in determining recovery value and the timeframe for return of capital.

Capital structure arbitrage has been a productive area for us. However, spreads between classes that were at historic levels have tightened significantly. We remain watchful for future opportunities of spreads between various slices of the capital structure. Consistent with other spread plays, the merger arbitrage area remains an interesting area for opportunities, but to a lesser degree than last year. In a market correction, this could change dramatically.

Longer term, as a consequence of the current environment, there will be interesting opportunities that arise from the upcoming bankruptcy wave. As companies restructure, they will create exit structures for which various tranches of value will fall into hands of rather unwilling and unnatural holders, creating an incredible opportunity set.

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

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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.

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.

Updates for Q1 2010*:

Q1 2010 Spinoff 1: In this situation, the Company (Co) was trading at a significant discount to our valuation analysis. Co was at $10 per share in Q1 2010. There are four main drivers of value in this situation. 1) The major catalyst of the spinoff itself is expected to unlock value. 2) The Company completed a significant special cash dividend. 3) The Company completed a successful convertible note dutch tender offer. 4) Management is highly incentivized. Our investment position (long equity plus options) allowed us to benefit from a wide range of outcomes. Hence, we created free upside optionality with minimal downside risk. Having initiated the position in Q1 2010 at $10, the price rose to $16.

Q1 2010 Spinoff 2: In this situation, the Company (Co) was trading at a significant discount to our valuation analysis. Co was at $10 per share in Q1 2010. There are two main drivers of value in this situation. 1) The major catalyst of the spinoff itself was expected to unlock value. 2) Our investment position allowed us to benefit from

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a wide range of outcomes. Hence, we created free upside optionality with minimal downside risk. Having initiated the position in Q1 2010 at $10, the price rose to $13.

Q1 2010 Partial Self Tender Offer: In this situation, the Company (Co) was conducting a partial self tender offer for nearly half of its shares. In a partial self tender offer, the Company effects a significant one time repurchase program at a clearing price to shareholders. Co was at $10 per share in Q1 2010. There were two main drivers of value in this situation. 1) The major catalyst of the completion of the tender offer itself. 2) Our investment position is attractive post tender offer on a pro forma basis. Having initiated the position in Q1 2010 at $10, the price rose to $10.50.

** Prices are normalized to $10 per share.*

A SPECIAL THANKS TO OUR INVESTORS

Denali Investors is fortunate to 1) be extremely selective in the manner we make investments, 2) be able to focus on research and investing as opposed to marketing and promotion, and 3) 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. Another important difference is that our investor base understands that the misplaced emphasis on a fund's Sharpe ratio, Value-at-risk, tracking error, or volatility is a particularly useless measurement for prudent management of capital.

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

I thank you for your trust and support.

NEXT OPENING: JULY 1, 2010

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 1st of each quarter.

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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 quarter.

Please note that all new assets received are subject to the two-year lockup period. Funds received by July 1, 2010, for example, will be open for redemption on July 1, 2012.

MISCELLANEOUS

Above all else, our focus remains on investing for survival.

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. Please feel free to visit if you are in the midtown area.

Respectfully,

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