

A strong year of growth
in book value, earnings,
and distributions—
we recovered performance,
built confidence, and
delivered results.



2010 Highlights

Earnings per share

Achieved strong EPS growth throughout the year, generating \$2.32 per share in 2010, compared to earnings per share of \$0.50 in 2009 and a loss of \$7.69 per share in 2008. This performance equates to a 28% return on equity.

Distributions

Improving cash flows drove growth — through margin expansion and retention of capital — and generated a solid return to shareholders through an

increasing distribution.

Have increased distributions to shareholders for five consecutive quarters. Distributions declared for 2010 totaled \$0.51 per share.

Book value per share

At year-end, this totaled \$9.24 per share, a 25% increase from \$7.37 per share in 2009 and a 110% increase from \$4.40 per share in 2008.

KKR Financial Holdings LLC (KFN) is a specialty finance company with expertise in a range of asset classes. KFN's core business strategy is to leverage the proprietary resources of its manager with the objective of generating both current income and capital appreciation. KFN is externally managed by KKR Financial Advisors LLC, a wholly-owned subsidiary of KKR Asset Management LLC, which is a wholly-owned subsidiary of Kohlberg Kravis Roberts & Co. L.P. KFN executes its core business strategy through majority-owned subsidiaries. Additional information regarding KFN is available at <http://www.kkr.com>.

Dear Fellow Shareholder,

2010 was a productive year for our company—a year of growth in book value, earnings and shareholder distributions. Despite macroeconomic headwinds and conflicting economic signs, we were able to achieve very strong performance while hitting our key metrics and delivering results. Further, we set out to do even more by leveraging the intellectual capital, insights and relationships across KKR.

On the heels of the credit crisis in early 2009, market conditions were extremely challenging and uncertainties plagued the financial markets, as did the true state of the global economy and prospects for its recovery. It was clear that these challenges would not be quickly or easily resolved. Many approaches were being offered to stimulate economic recovery and all companies were confronted with the reality of the changing competitive landscape.

At that point in time, KFN's business model was focused on holding predominantly senior secured loans financed through collateralized loan obligations (CLOs). As in the broader markets, there was profound disruption in the structured finance market.

Fortunately, we saw opportunity in this new market reality, and set out to reposition KFN for growth and to counteract our fear that global economic stimuli would result in an aftershock.

As we enter 2011, we are a different business from what we were.

This year's letter discusses the views that have influenced our current strategic positioning of the business.

The KKR Platform — Embracing New Opportunities

Every economic cycle offers opportunities. Our manager, KKR, excels at adapting strategies to market conditions, and committing capital at every level of a company's capital structure across geographies. In addition, through KKR's ownership of more than

volatility provides opportunity for differentiation through research and proprietary sourcing.

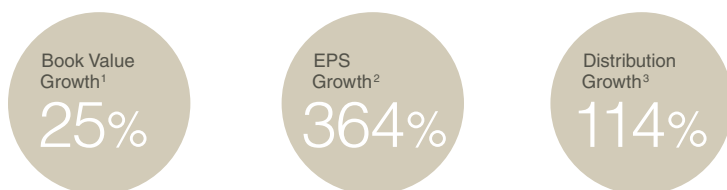
Through the lens of KKR's 34+ years of sourcing and investing across asset classes, we saw a unique and expanding opportunity to generate attractive and consistent real returns in addition to maximizing value from our CLOs.

Natural Resources is an example of an opportunity that became even more attractive to us given KKR's dedicated

Structured Finance Market Disrupted — CLOs Still Valuable

With our legacy business in senior secured credit, we still maintained a view that syndicated bank loans as financed through CLOs would continue to be appealing given their cash yield and inflation protection. Further, deploying capital to a liquid credit strategy using non-mark-to-market leverage through CLO structures was a demonstrated way to generate returns. However, the market structures and liability costs in 2010 did not meet our requirements, and it was uncertain when such terms would achieve our hurdles.

Our CLOs were issued during the peak of the credit cycle, not the trough. With an attractive cost of financing, conviction in the assets financed by these structures and plenty of room for reinvestment, our CLO structures represented a unique and valuable opportunity for current income and growth. We continue to focus our efforts on protecting cash flows and recycling proceeds from any asset sales and principal pay-downs into higher yielding positions to maximize the long-term residual value of these structures and grow net interest margin.



60 portfolio companies, we have unique insights into industries and the real economy in general.

When the lending environment tightens, opportunities to deploy capital to proprietary transactions such as mezzanine and distressed abound. We generally seek to deploy capital where the supply-demand imbalance is most acute and, as fundamental investors, we favor an environment where

platform in energy and infrastructure. Separately, with our expectation that areas of credit dislocation would continue, we saw compelling opportunities with proprietary credit through KKR's mezzanine and special situation strategies. The latter includes distressed and rescue financing opportunities.

¹ Reflects change in book value from December 31, 2009 to December 31, 2010.

² Reflects change in EPS for the year ended December 31, 2009 as compared to the year ended December 31, 2010.

³ Reflects change in distribution declared for the fourth quarter 2010 as compared to the fourth quarter 2009.

Inflation — A Looming Reality

With our assets and liabilities predominantly floating rate and indexed to LIBOR, a rising rate environment would generally benefit KFN. In our view, the combination of concerted fiscal and monetary stimulus and the large and growing budget deficits made it more likely for long-term rates to rise than fall. However, we were mindful that markets can change quickly, and determined the most prudent portfolio would be positioned to perform well whether material price inflation came to pass or not.

KFN—A Different Business Today, A Versatile Capital Allocation

Transitioning KFN to leverage the full spectrum of KKR capabilities, relationships and insights across multiple asset classes just made intuitive sense. We created an opportunity to deploy capital in several areas we were seeing substantial opportunity to maximize return on capital, including our historical exposure to syndicated bank loans financed through CLO structures. In doing so, we could diversify risk, potentially increase our expected returns on capital and still target a vast majority of yield-producing investments.

With all of KKR's capabilities in play, we expect 2011 to be characterized by meaningful capital deployment as we continue to grow. At the core of our capital allocation strategy is versatility. We have developed a proprietary

but flexible model to optimize how we allocate capital while mitigating risk. While we seek exposure to several asset classes, we deploy capital based on the relative opportunity set and, to transactions that meet our return

Opportunity Set

Asset Class	Current Perspective
Senior Secured Credit (financed through CLOs)	CLO market re-opening; limited but growing opportunity to deploy capital in our legacy business.
Senior Secured Credit (non-CLO)	Strong risk-adjusted return potential, senior position in capital structure. Our focus is on CLO-eligible, secured term loans and bonds, and some high yield, based on fundamental credit analysis, with a significant focus on principal protection.
Natural Resources	Attractive market dynamics (liquidity needs by oil majors to fund shale exploration, global demand for cash) have created an attractive opportunity. Our current focus is on acquiring conventional oil and gas producing assets or royalty interests with little exploration risk and substantial producing developed reserves.
Mezzanine	New buyout activity combined with limited financing availability creates opportunity. Our focus is on dedicating capital to control or non-controlled distressed opportunities globally.
Special Situations	Despite official end of recession, many companies remain in distress/require new capital. Our focus is on sourcing private debt transactions for third-party sponsors around the globe.
Private Equity	Post-recession periods have historically been very attractive periods for private equity investing and KKR is well positioned to capitalize on such opportunities.
Commercial Real Estate	Significant valuation excesses in 2005-2008, coupled with traditional major investment managers exiting the business creates significant opportunity for KFN. Our focus is on the opportunity to earn outsized risk-adjusted returns by providing flexible capital solutions to real estate owners and operators in need of capital to meet upcoming maturities, and to deleverage, improve and retenant their respective assets.

We have developed a proprietary but flexible model to optimize how we allocate capital while mitigating risk.

on capital hurdle rates and where our manager has a competitive advantage and expertise.

Regardless of the environment, the management of our portfolio and decisions to allocate capital are anchored by several tenets:

First, to generate a reliable cash flow stream to support an attractive cash distribution to shareholders. This needs to be achieved even during an inflation-induced interest rate environment.

Second, to provide opportunities for capital appreciation and positive return skew by participating in transactions such as private equity, mezzanine and distressed opportunities where the return potential is more than coupon interest payments and a recovery of par.

Third, to be diversified so that cash flows and earnings aren't solely dependent on one beta exposure and financing does not put the business in harm's way.

2010—Taking Stock, Key Metrics Show How We've Transformed

It was a successful year for our company. We generated a 28% return on equity (ROE) and provided an attractive distribution to our shareholders.

While we benefited from price appreciation in the leveraged loan and high-yield bond markets, the increased liquidity afforded borrowers was also of benefit to us as we continued to drive

2010 Debt and Capital Raising Initiative:

- We raised new debt. In January, we issued \$172.5 million of 7.5% convertible notes due January 2017 to refinance \$95.2 million of 7% convertible notes due 2012.
- We paid down and then paid off our \$150 million credit facility, due to mature in November 2011, and entered into a new \$250 million revolving credit facility with an extended maturity of May 2014. In addition to the increased borrowing capacity, this facility bears interest at a lower cost of funding—LIBOR plus 3.25% as compared to LIBOR plus 4% and raised our distribution payout restriction from 50% to 65% of our estimated annual taxable income.
- During December, we raised \$175.7 million by issuing 19.4 million common shares.

net interest margin, and in turn, earnings and cash flows by redeploying capital at higher yields to new opportunities. Within our CLO structures we generated a 14% increase in net interest margin and we generated a 20% increase across our entire portfolio.

We also achieved superior flexibility in managing our cash flow in 2010 through debt raising and capital initiatives. Importantly, today we have no mark-to-market financing exposure and comparatively low recourse leverage for a specialty finance company. The only meaningful short-term liquidity needs are our 7% 2012 convertible notes, which totaled \$180.6 million as of December 31, 2010.

The Landscape Ahead — Our Commentary

At the beginning of this letter, I expressed my confidence that KFN is positioned to capture the opportunities presented by the market. Let me close with our view of what will drive the markets in 2011 (which we keep in mind in everything we do).

Washington DC

Only time will tell the extent to which Congress and the White House can really work together to address problems — or whether we are in for two years of stalemate. Both sides understand the importance of the economy to the 2012 election, so the stakes are very high. When the Fed pulls QE2, the markets will likely feel the impact.

On the financial reform front, the impact of Dodd Frank on financial markets remains uncertain. Clearly Basel III will have an impact.

European Sovereign Debt

This could be an important issue, especially for the Eurozone periphery (Greece, Ireland, Portugal and Spain). If another bailout is needed, creditors are going to be impaired—and we're not sure banks and insurance companies have capital reserved for such an event.

U.S. Housing Market

Despite the euphoria, U.S. home prices keep weakening based upon recent data. The latest Case-Shiller Home Price Index was actually down 1.6%* from a year ago. Inventory overhang and persistent unemployment are not helping, and rising mortgage rates will not either.

Chinese Growth (and Inflation)

It is becoming harder and harder for the Chinese government to manage double-digit growth without significant inflation. The real question is whether the Chinese can hold off putting the fire hose to their economy long enough for the rest of the developed world to get on a sustainable growth trajectory.

U.S. Treasuries and the “risk free” Oxymoron

Unfortunately, this is playing out as we expected. Investors are not buying 10-year treasuries anymore for 2.5% yields—see Chinese Growth (and Inflation). It does not feel like the dollar is going to lose its place as the global reserve currency anytime soon, but

We know our portfolio,
we know the quality
of our opportunities, and
we know the quality of
our team.

the yield curve is starting to betray the fact that the U.S. government will not be able to finance itself for free forever.

The Refinancing Wall (aka the Pig in the Python).

Credit markets continue to make real progress kicking the proverbial can down the road. However a real and robust IPO market is the key to solving the issue.

State and Local Issues in the U.S.

This one is new to the list and we are working to better understand and quantify potential impacts. We all know

about the large states (i.e. Illinois and California) who are also very large employers facing tough spending choices for this budget cycle. On the margin, this could damage employment or consumer confidence. Higher taxes are not helpful either.

With all this said, KFN has witnessed remarkable change over the past two years. We have an exceptionally talented group of people working together with creativity and determination to provide KFN with substantial opportunities for value creation. We know our portfolio, we know the quality of our opportunities and we know the quality of our team.

We believe that we are on the path toward building meaningful shareholder value and thank you for your continued support.

Sincerely,



Bill Sonneborn
Chief Executive Officer

* November 2010 20-city composite as reported January 25, 2011.

KFN is back. We're generating returns across economic cycles, and positioned for continued growth.

1. Two years ago, we faced great change and uncertainty—a volatile market and an unforgiving economy.

At the start of 2008, the global economy was entering a deepening recession and the landscape for financial services was forever changing. Almost all financial companies faced substantial challenges — we were not alone. By the end of 2009,

the debt and equity markets began to rally but most finance companies stumbled to regain their footing and lending remained at all-time lows. While massive global actions were underway to stimulate the recovery, we had long-term concerns about inflation and interest rates.

2. With uncertainty came opportunity, and we are today capitalizing on it by deploying capital behind supply/demand imbalances.

In 2009, our focus on additional opportunities emerged out of the credit crisis and what we were seeing across the globe. Commercial and investment banks—limited in

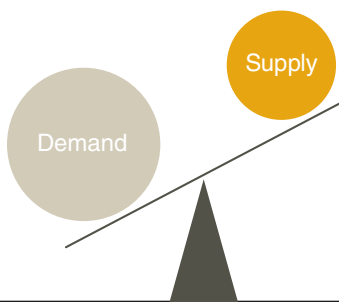
their ability to underwrite new financings — struggled to replenish their capital bases and reduce leverage, and debt originated in the overheated market from 2004 to 2007 was coming due. We were seeing

increasing covenant breaches and defaults from borrowers with overleveraged capital structures, and a record amount of capital raised by LBO-focused private equity firms that is still uninvested today.

3. Recognizing our ability to source opportunities that others simply could not, we began shifting the mix of our business.

We rethought our capital allocation strategy to leverage more of our expertise, relationships and insights to source

new opportunities — moving us beyond corporate credit. These shifts are subtle but we expect these moves to help drive value in the future.





Strategic Diversification:

Where We Were

- Senior Secured Credit, (financed through CLOs)
- Private Equity
- Residential Mortgage-Backed Securities

Where We Are Going

- Senior Secured Credit, (financed through CLOs)
- Private Equity
- Mezzanine
- Natural Resources
- Special Situations
- Commercial Real Estate



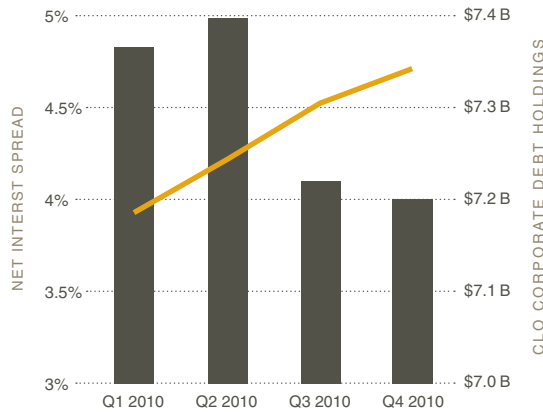
4. To capture new growth and opportunities, we capitalized on our greatest strength—our partnership with KKR. One firm, many resources.

We focus on sourcing proprietary opportunities by leveraging our manager's global network of relationships, and capitalizing on KKR's 34+ years of investment experience.

* Participation of KKR Private Equity, KKR Capital Markets, and KKR Capstone personnel in the public markets investment process is subject to applicable law and inside information barrier policies and procedures, which may limit the involvement of KKR Private Equity, KKR Capital Markets, and KKR Capstone personnel in certain circumstances and our ability to leverage our relationship with KKR. Discussions with Senior Advisors and employees of KKR's managed portfolio companies are also subject to the inside information barrier policies and procedures, which may restrict or limit discussions and/or collaborations with us. KKR Capstone is owned and controlled by its senior management and not KKR.

We're building on our strengths, and with KKR's capabilities in play, we expect to continue to diversify and grow.

Growing Net Interest Margin
 ■ CLO Corporate Debt Holdings Average Balance
 — Net Interest Spread earned from holdings in our CLOs*



5. But some things have not changed — corporate credit financed through CLOs remain integral to our business.

We have a competitive advantage with our CLO liability structure. We continue to preserve and harvest the value from these structures by recycling capital into higher yielding assets, and it is still a big part of our business. With 48%

of our capital deployed in these structures at year-end, a weighted average funding cost of LIBOR plus 53 bps and remaining investment periods of two to three years, these CLO structures represent an opportunity for continued earnings growth through net interest margin expansion.

6. For greater flexibility, we also remain committed to our corporate structure as a publicly traded partnership (PTP). It is a business model like no other.

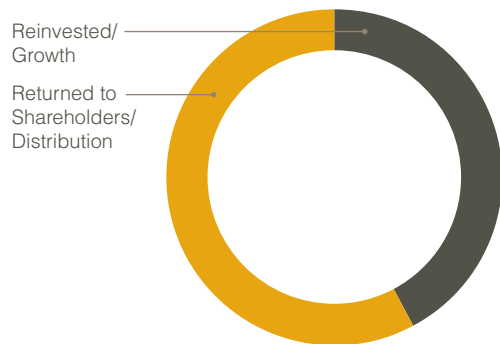
Our structure as a PTP aligns with our two objectives of generating income and growth. It provides us with the flexibility we require to seek the best opportunities — providing attractive total returns to our shareholders — while enabling us to retain capital for growth.

In fact, we have more flexibility in asset mix as a PTP than we otherwise would have as a real estate investment trust or business development company (BDC), and our board can determine distributions on a quarterly basis.

Regulatory Flexibility	KFN	BDC
Able to hold more than 30% of portfolio in non-U.S. Investments	YES	NO
Able to incur a leverage ratio greater than 1x	YES	NO
Able to retain capital to grow by not having to distribute 90% of taxable earnings to shareholders	YES	NO

* Excludes accelerated accretion income from prepayments and amortization of capitalized costs.

Primary Uses of Cash



7. We are now achieving our objectives: growing our business and increasing shareholder value.

We maintained a cash distribution at a premium to treasury rates — and for the fifth consecutive quarter, we increased our cash distribution to shareholders. We also were able to retain earnings

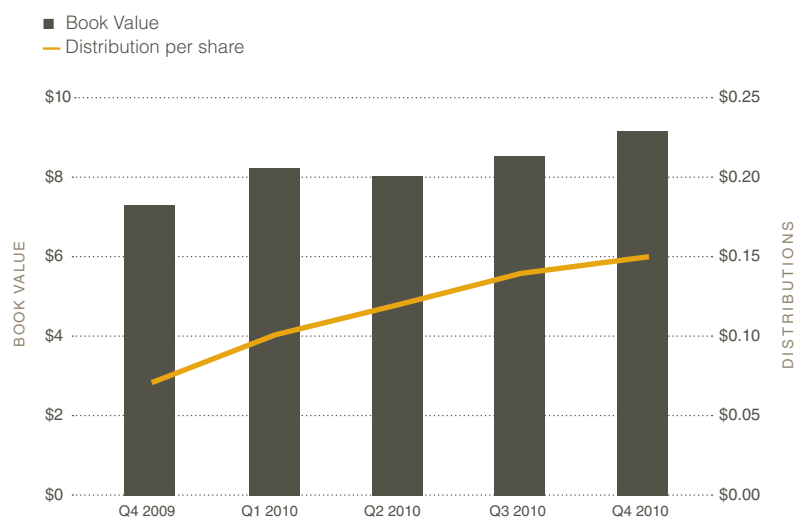
for opportunistic reinvestments that will help grow our enterprise value. We have significant capital and scale to continue this growth and shareholder value.

8. Our strong franchise and business model sets the stage for our continued success in 2011.

We have a strong balance sheet and growing momentum in actively deploying capital. During 2010, we continued to achieve strong earnings growth (a 28% return on equity), improved

cash flow, increased distributions, and saw book value increase 25% from a year ago. All of these metrics underscore the value of our franchise — and our success at transforming our business. Simply put, we are today a higher performing business than we were before.

2010 Quarterly Book Value and Distributions



Consolidated Financial Data¹

(in thousands, except per share data)

	2010	2009	2008	2007	2006
Results of Operations:					
Investment income	\$ 505,359	\$ 572,725	\$ 948,588	\$ 872,373	\$ 627,933
Interest expense	156,852	289,374	564,614	617,504	430,384
Provision for loan losses	29,121	39,795	481,488	25,000	–
Other income (loss)	143,352	(96,275)	(906,837)	62,012	20,753
Non-investment expenses	90,972	70,061	73,250	86,881	97,434
Income (loss) from continuing operations before income tax expense (benefit)	371,766	77,220	(1,077,601)	205,000	120,868
Equity in income of unconsolidated affiliate	–	–	–	12,706	5,722
Income tax expense	702	284	107	256	964
Income (loss) from continuing operations	371,064	76,936	(1,077,708)	217,450	125,626
Income (loss) from discontinued operations	–	–	2,668	(317,655)	9,706
Net income (loss)	371,064	76,936	(1,075,040)	(100,205)	135,332
Basic income (loss) per share from continuing operations	\$ 2.33	\$ 0.50	\$ (7.71)	\$ 2.38	\$ 1.53
Basic income (loss) per share from discontinued operations	\$ –	\$ –	\$ 0.02	\$ (3.53)	\$ 0.12
Basic net income (loss) per share	\$ 2.33	\$ 0.50	\$ (7.69)	\$ (1.15)	\$ 1.65
Diluted income (loss) per share from continuing operations	\$ 2.32	\$ 0.50	\$ (7.71)	\$ 2.38	\$ 1.53
Diluted income (loss) per share from discontinued operations	\$ –	\$ –	\$ 0.02	\$ (3.53)	\$ 0.12
Diluted net income (loss) per share	\$ 2.32	\$ 0.50	\$ (7.69)	\$ (1.15)	\$ 1.65
Distributions per common share:	\$ 0.43	\$ 0.05	\$ 1.30	\$ 2.16	\$ 1.86
Consolidated Balance Sheet Data:					
Total assets	\$ 8,418,412	\$10,300,005	\$12,515,082	\$ 19,046,025	\$17,565,177
Total borrowings	6,642,455	8,970,591	11,461,610	13,425,106	8,681,157
Total liabilities	6,775,364	9,133,347	11,851,737	17,401,486	15,841,746
Shareholders' equity	1,643,048	1,166,658	663,345	1,644,539	1,723,431
Book value per common share	\$ 9.24	\$ 7.37	\$ 4.40	\$ 14.27	\$ 21.42

¹ Selected financial data as derived from the audited consolidated financial statements should be read together with the more detailed information contained in the consolidated financial statements and associated notes, and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere in this Annual Report.



[LAST PAGE OF FINANCIALS]

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⁽²⁾ Compensation

⁽³⁾ Nominating and Corporate Governance

⁽⁴⁾ Affiliated Transactions

Corporate Data

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