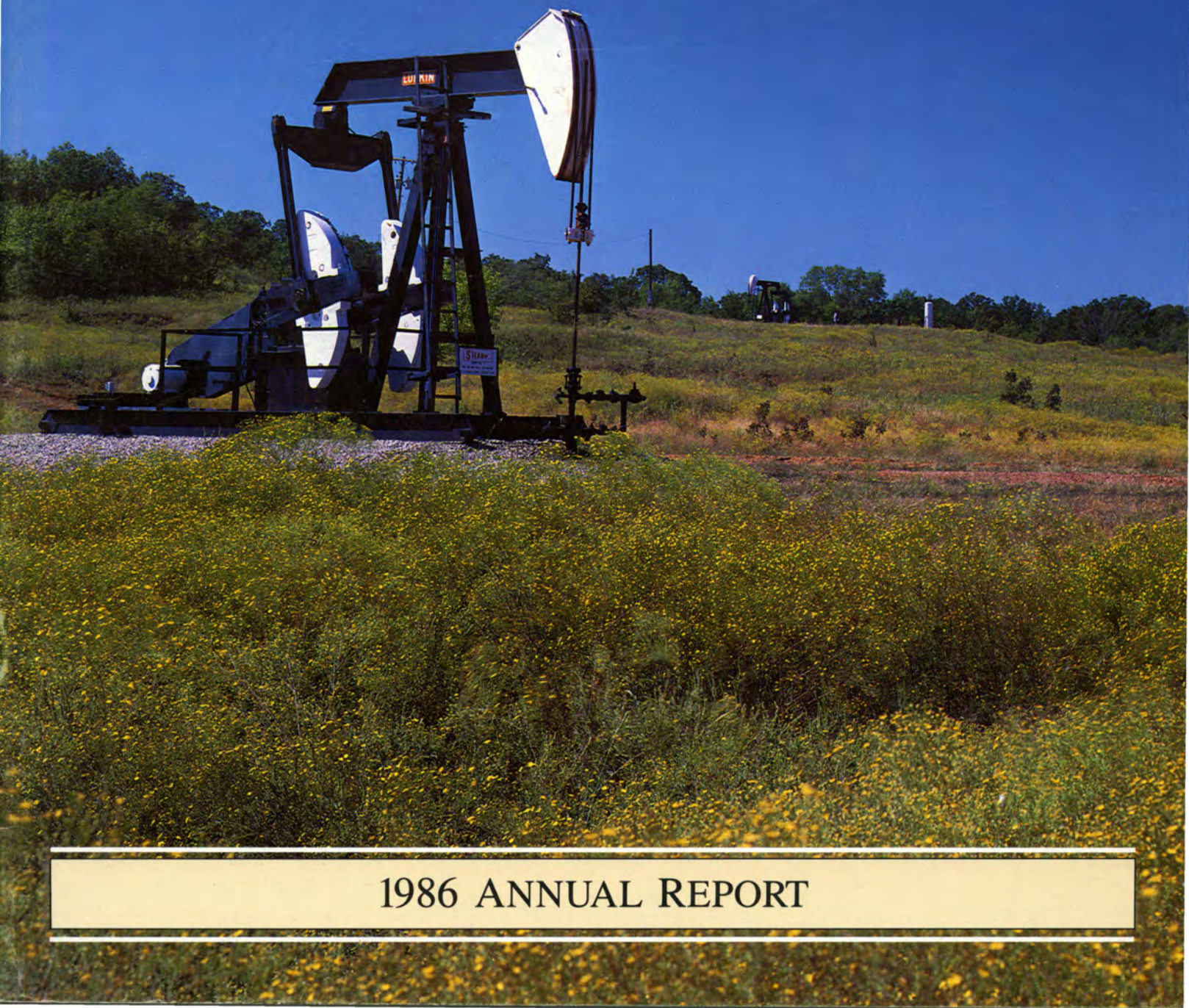


LUFKIN INDUSTRIES, INC.



1986 ANNUAL REPORT

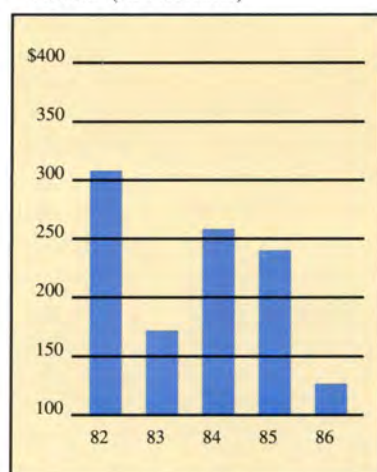


FINANCIAL HIGHLIGHTS

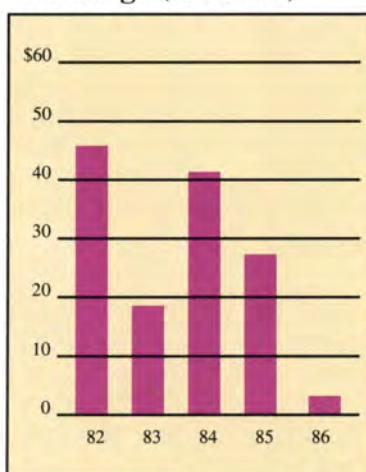
(In thousands of dollars, except per share data)

Years ended December 31	1986	1985	1984	1983	1982
Net sales	\$130,442	\$241,894	\$258,006	\$170,406	\$309,664
Net earnings	3,887	28,615	40,973	19,573	46,957
Net earnings per share	2.27	16.64	23.83	11.38	27.12
Total assets	272,611	292,471	285,134	266,065	260,224
Cash dividends per share	10.00	11.00	10.00	9.00	10.00
Book value per share	139.77	147.85	142.21	128.38	125.99

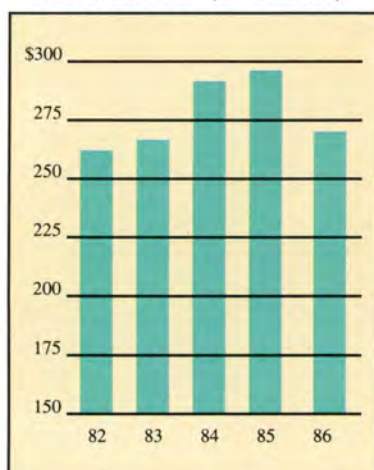
Sales (in millions)



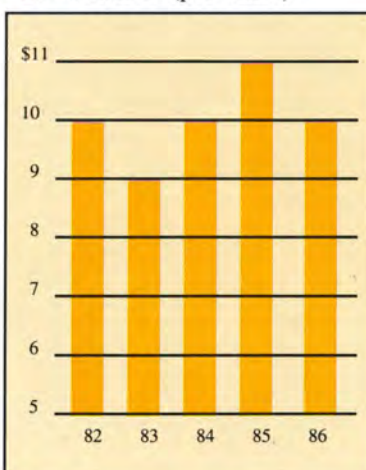
Earnings (in millions)



Total Assets (in millions)



Dividends (per share)



Cover: A LUFKIN conventional crank-balanced unit works in harmony with a pastoral landscape.
Opposite: Silhouetted against a cerulean Montana sky, a Mark II sits atop a precipice.

TO OUR SHAREHOLDERS



As a result of the continuing downward plunge of the oil industry, our total sales decreased 46 percent from \$241.9 million in 1985 to \$130.4 million in 1986. Consequently, net earnings dropped 86 percent from \$28.6 million in 1985 to \$3.9 million in 1986.

Markets for the company's pumping units were adversely affected by the instability in the price of oil and the resulting decline in drilling activity during 1986. Hence, the number of pumping units shipped in 1986 decreased 65 percent and the average unit size shipped dropped nine percent.

Net sales in the trailer Division's products decreased 14 percent, from \$61.3 million in 1985 to \$52.9 million in 1986. While the number of trailers sold in 1986 decreased only three percent, the major cause for the 14 percent decrease in net sales was the downward price pressure resulting in a decrease in the selling price of trailers.

The Trailer industry throughout the nation was down about 20 percent in 1986. Considering that, our Trailer Division had a relatively good performance. We have added a second shift on the van production line and in the first weeks of 1987, shipments of vans have increased.

Throughout a clouded 1986, we have concentrated our efforts in three essential areas: (1) to provide goods and services of unequaled quality to our

customers; (2) to maintain the best possible climate for career growth and achievement for our employees; and (3) to enhance constantly our competitive position in order to optimize future benefits for our shareholders.

Several years ago an article published in Fortune magazine observed, "Lufkin Industries so dominates its prosaic business that its name is as familiar as Coke and Kleenex." We strive every day to be certain that such a complimentary statement will deservedly be said of us in the years ahead.

In other areas of this Annual Report you will be made aware of our continuing efforts to search for diversity and sound new products and ideas. During 1986, several new product lines were established which we believe will bring substantial benefits to our company.

We believe that with depleted and irreplaceable oil reserves and with an ever-growing world appetite and need for petroleum products, a company with staying power, such as ours, is in the most advantageous position to continue world leadership.

Lufkin Industries has faced trying times before, and on each occasion we have emerged a stronger company, more responsive to the needs of our customers and owners. We have a long and colorful history behind us, a strong foundation upon which to build as we stretch our capabilities to meet and conquer the situations that come.

Frank B. Stevenson
President and Chief
Executive Officer

In 1986, LUFKIN was challenged as never before, unless it was worse during the Great Depression years.

However, challenge brings out the best in all of us when it presents a "do or die" set of circumstances. I am proud to report that your team—management and employees—met the situations head-on with enthusiasm and confidence. There was streamlining as well as strengthening of our operations and facilities. As a result of our actions in 1986, we are well-positioned to continue our achievements in the manufacture of gearing, oil field and transportation equipment as well as to increase our potential to serve a wider domestic and world market.

Opposite: A Lufkin Mark II pumps its bounty from the Land of the Big Sky in Richland County, Montana.





MACHINERY DIVISION

The Machinery Division consists of several component groups which design, manufacture and market oil field products, industrial and marine gearing, along with castings, general steel fabrications and other special products which fit the manufacturing capabilities of the plant. These basic groups are engineering, foundry, machining, steel fabrication and sales, along with other support functions.

This Division manufactures and markets a complete line of oil field sucker rod pumping units, including crank-balanced, air-balanced, Mark II, beam-balanced, slant hole and portable trailer-mounted units. The conventional crank-balanced unit is the most widely accepted and accounts for slightly less than 60 percent of the pumping unit revenue. The Mark II and air-balanced units contribute approximately 35 percent, with the beam-balanced, slant hole and trailer mounted units accounting for about five percent of the oil field products revenue.

The Machinery Division also offers a complete line of industrial, marine and special purpose gear units. The company is considered one of the leaders in high performance gear drives for transmitting high horsepowers at high speed. The gear product line includes units that weigh from approximately 300 pounds up to 250 tons and are marketed worldwide. Gear units are applied in the petrochemical, coal processing, rubber, sugar, marine propulsion, plastics, electric generating and food processing industries, and any other industry requiring heavy duty gear drives.

Gear units are considered an engineered product and in the past have competed best in the lower volume, special application market. Efforts are being made to develop markets in the standard lines of gear units where higher volume sales and production can be achieved.

The Machinery Division continued in 1986 a program for wider diversification. It devoted resources to the development of products and components for other markets such as electric generating, ductile and gray iron castings, wood products, steel buildings, and paper, mining

and defense industries. The pursuit of this business is being used as a search for, and possible development of, additional products and markets which will reduce the company's sensitivity to the cyclic nature of its oil field related products.

During the past year, the machine shops have continued to follow and improve "just-in-time" manufacturing in which parts are machined in manufacturing cells linked to assembly wherever feasible. These components are produced as they are needed in quantities required



Opposite: Completion of the small casting facility was the major capital project in 1986.

Right, Top: The impact molding machine in the small casting facility produces quality castings at lower cost.

Right, Bottom: The gear product line includes units that weigh from 300 pounds to 250 tons.

MACHINERY DIVISION

for the purchase order. In addition, parts purchased from vendors are received, kept and used directly at their end-use point.

All this emphasis on simplifying the manufacturing efforts is to enhance the operations that add value to the product and eliminate those which do not. The net result is a major reduction in overall effort in producing the product, which in turn reduces cost and improves value to the customer.

Another primary emphasis during 1986 was the improvement in manufacturing of industrial gears. Manufacturing cells were established for production of industrial gear reducer small parts such as bearing carriers, oil seals and small gear blanks. Benefits derived from these systems included reduction of excessive material handling, work scheduling and reporting, delays, scrapped parts, machine set-up and change-over times

and paperwork. This resulted in reduced lead times, improved quality and reduced costs in production.

Several product components which previously were purchased from outside vendors were brought back into the plant for more economical manufacturing at greater reduced lead times. The capacity to grind large gear/shaft assemblies within the machine shop was developed, reducing delivery lead times and making LUFKIN less dependent upon outside vendors. In addition to the advantages realized for customers, this expanded "in house" manufacturing of product parts has provided continued employment for company employees.

A capital project of major significance to the company's foundries was the completion of the second phase of the small casting facility. Highlight of this installation is the new impact molding system. Castings produced in this system have ex-

ceeded expectations in improved surface finish, superior dimensional accuracy and reduced cleaning times. This has resulted in a greater capability to provide quality small castings at a lower cost.

The computer has become an increasingly important productivity tool in the foundry. Computer aided design and drafting tools used in foundry engineering, computerized process control equipment used in casting production and computer software used to assist in scheduling, materials management, maintenance and laboratory functions have helped to improve both the quality and cost efficiency of the overall operation.

Although there is increasing use of new technology, people remain the key attribute of a good foundry. The commitment of the LUFKIN foundryman to quality, self improvement and the use of sound foundry principles on a daily basis is the single most important success factor.

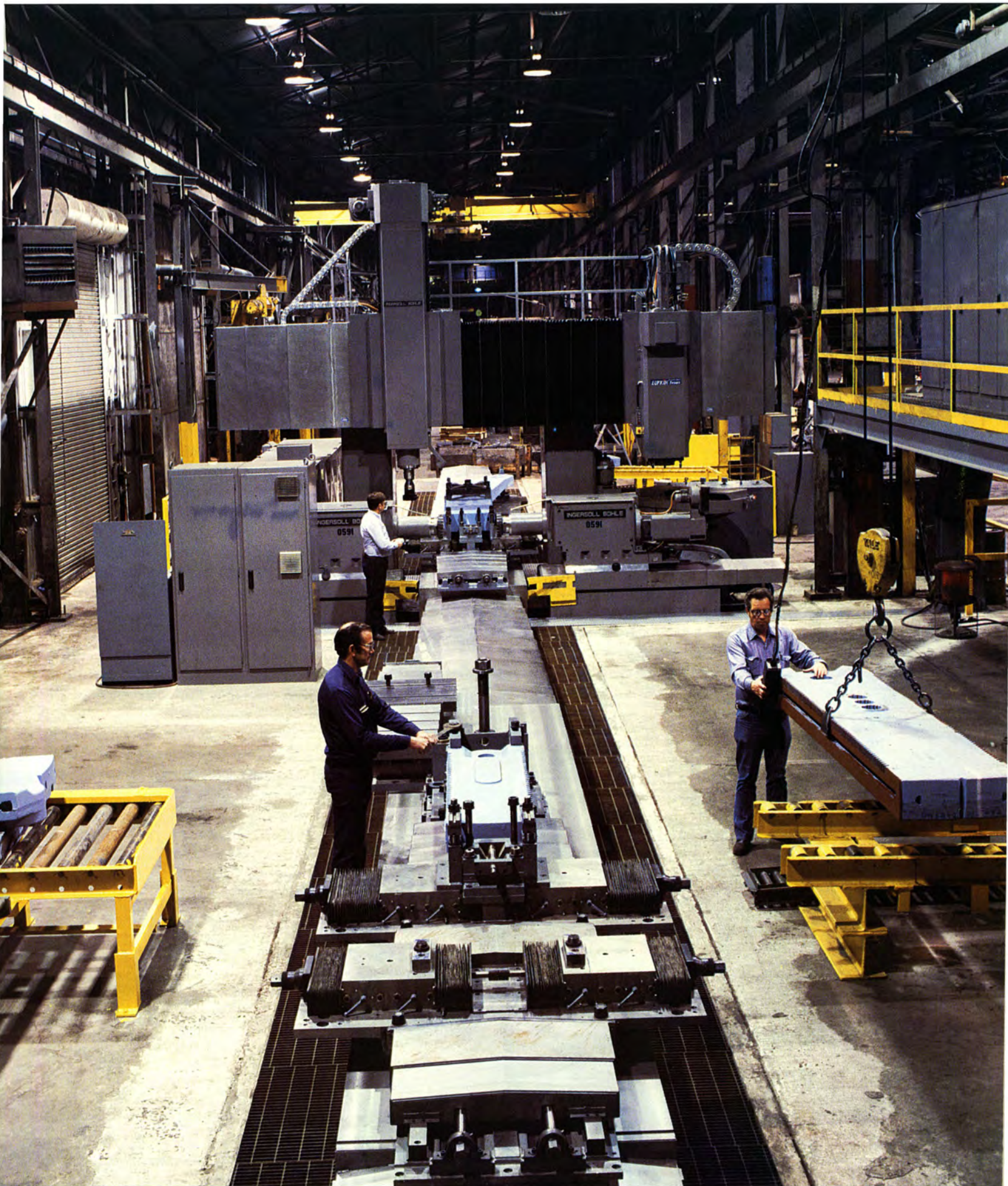
With the addition of the impact molding system in 1986, the new ductile iron foundry in 1985, the existing large casting facility and cupola, arc and induction melting capability, LUFKIN's foundries are well equipped to service the requirements of the Machinery Division and the ductile and gray iron castings markets.

Structural Steel Operations is an integral unit of the Machinery Division, providing steel fabrication in the welding shop, and assembly and shipping of oil field pumping units at the final assembly and shipping department. Fabrication of heavy steel housings for the company's broad line of industrial gears is performed at the heavy weldment shop.



Left: This massive gear box will house a 4000 horsepower rubber mill gear drive which will be shipped to Korea for installation in a tire plant.

Opposite: This \$1.5 million computerized numerically controlled machining center produces pumping unit cranks in a single machining operation.



MACHINERY DIVISION

Structural Steel Operations also serves as a general steel fabricator for a diversity of applications including structural steel buildings of all types, material handling equipment, pollution control components, maintenance parts for coal- and lignite-fired electricity generating stations, paper mills, sawmills and communications equipment.

At the welding shop where pumping unit structural sub-assemblies are fabricated, the plant is arranged in seven distinct factories. Each factory contains all the necessary conveyors, machinery and tooling to convert raw steel into a primary pumping unit component. The heavy weldment shop is arranged as a job-shop where steel plate up to 16 inches thick is transformed into massive gear reducer housings, some as heavy as 30 tons. Also built in this shop are pressure vessels, maintenance components for utility plants and large specialized fabrications.

In the final assembly and shipping department, pumping unit sub-assemblies are drawn from stock,

assembled, painted to customer specifications and prepared for shipment. After final quality assurance check, the units are loaded on flatbed trailers for shipment. Units for overseas shipment are crated or packaged in intermodal containers.

Machinery Division support departments contributed toward the Division-wide effort for productivity improvements and cost reductions. Improvements in customer order processing, inventory management techniques and information systems are examples of accomplishments during 1986. New computerized maintenance, purchasing and traffic systems were placed in service. These systems provided immediate assistance in both productivity improvement and cost containment. The purchasing department worked closely with vendors to remove costs from the supply chain. Significant cost reductions were achieved without compromising the quality of purchased materials.

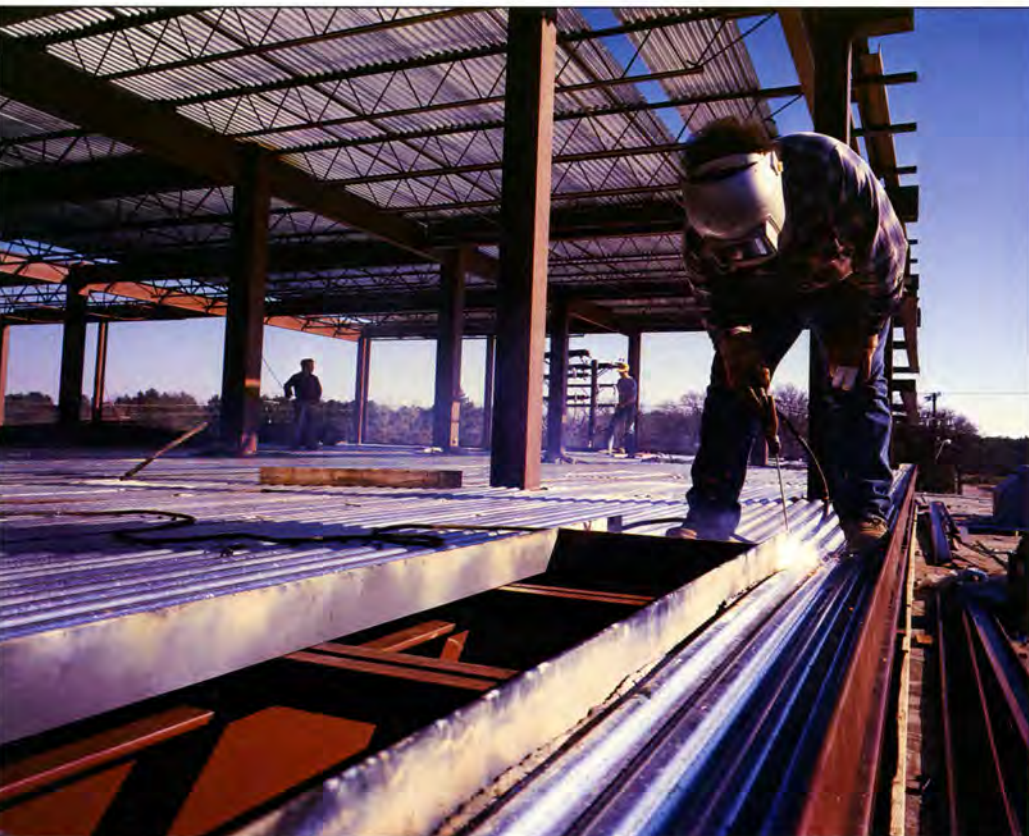
The Machinery Division's sales department suffered through another year

of low demand for pumping units and soft demand for industrial and marine gearing. During 1986, prices for virtually all oil field equipment have been greatly depressed due to an abundance of manufacturing capacity with each competitor trying to capture business in a market where demand was the lowest in recent history. This has been complicated further by a glut of used pumping units coming into the market as a result of marginal oil wells being plugged and the units being used on a new well or put into the used market.

To enhance LUFKIN's sales position, field services were expanded for oil field customers by building a new service center in Oklahoma City and by expanding service capabilities in Bakersfield, California; Casper, Wyoming; and Kilgore and Odessa, Texas.

A manufacturing licensee in Indonesia was established in 1986, bringing to four the number of countries where LUFKIN pumping units are manufactured, including Canada, Argentina, Venezuela and now Indonesia.

These are difficult times in the oil related industry. Still there is confidence and optimism within the company. With almost 85 years of strength and impeccable reputation undergirding its efforts, LUFKIN will continue to produce products sought by the trade because of their conservative design and quality manufacture and customer service before and after the equipment is delivered. When the ill winds have calmed, LUFKIN will be ready to serve the demands of the future.



Left: Structural steel was furnished for a poultry processing plant, depicting a diversity in the company's business during 1986.

INDUSTRIAL SUPPLIES DIVISION

The Industrial Supplies Division is located on approximately 14.5 acres at the intersection of the West Loop and State Highway 94. It is housed in a 126,000-square-foot warehouse containing \$2.2 million of inventory purchased from 692 vendors, 60 percent being industrial items, 25 percent being plumbing items and 15 percent being poleline hardware items.

Industrial Supplies delivers to customers within a 150-mile radius of Lufkin, ranging northwest to Rockwall, west to Marlin, south to Houston, east to Bon Wier and north to Kilgore. Scheduled routes cover customers a minimum of once a week, while hotshot deliveries are made 24 hours a day, seven days a week, with after-hours deliveries made mainly by outside sales personnel. The sales force of Industrial Supplies is comprised of the sales manager, two industrial sales representatives, one plumbing sales representative, one poleline sales representative, three counter sales representatives, and three industrial and one plumbing sales representatives to serve the Division's varied customer base.

Considering the sagging Texas economy, 1986 was a successful year for this Division. Sales dropped only slightly

from \$6.7 million to \$6.5 million, mainly due to increased pricing competition from supply houses attempting to meet cash flow problems. Many supply houses are expanding territories due to decreased sales within their normal range.

The highlight of 1986 was the completion of a bath and kitchen showplace in November. Displaying the latest American Standard fixtures, Elkay sinks, Price-Pfister and Valley trim, the new showroom has a grand opening scheduled in March, 1987.

With the completion in late 1985 of the distribution control system, a computer software package designed specifically for supply houses, the Industrial Supplies Division reaped many benefits almost instantaneously. This continued throughout 1986, with the most notable result being a drop in inventory from \$3 million to \$2.2 million, while supporting the same sales volume. Many new uses of the vast information now available through the distribution control systems are surfacing almost weekly.

Three new incentives have been added to increase sales in 1987. The new bath and kitchen showroom is designed to bring customers to the point of sale. A welding specialist will demonstrate welding equipment and supplies to

potential customers, by taking the equipment to them in an outfitted van. Also, electric motors have been added to the product lines of this Division.

There is a cautious optimism about business in 1987. Much is dependent upon the housing market which affects plumbing sales, poleline hardware and lumber related industrial sales. Also, the Division's sales to the Trailer and Machinery Divisions are imminently affected by the economic stability of the transportation and oil related industries.

Below: Several models of bath and kitchen fixtures and the many trims available are displayed in a recently constructed showroom.



TRAILER DIVISION

The Trailer Division was the bright star in Lufkin Industries' constellation during 1986. It continued its record setting pace in van production while at the same time introducing two new trailer designs into the trailer line.

Van production reached a new high of 3,048 vans in 1986, eclipsing the record high 3,039 vans produced in 1985. J.B. Hunt Transport, Inc. continued to be the company's largest customer, with that business accounting for 41 percent of all vans produced. Adding flatbeds, dumps and special order trailers to the van total, the composite total of all trailers produced was 3629.

The new drop frame flatbed and the ultra light dump trailers are expected to command their portion of the market in 1987. The steel dump trailer is a lightweight design but tough in endurance, and it is easier to maintain than an aluminum dump. It gives the customer a greater pay load capacity. With projec-

tions of more highway repairs and new construction it is expected that the new dump trailer will have a good market in 1987.

The new drop frame flatbed trailer will provide contract carriers with a lightweight float with a drop deck for specialized hauling and easier loading and unloading.

During 1986, there continued the upgrading of trailer manufacturing facilities, including many changes in the production line. Among these was the installation of the computerized numerically controlled system to modernize and upgrade the pierce rivet side machine. This machine now can handle virtually any van side configuration, with set-up time reduced drastically.

A new programmable press break machine was installed in 1986 to make more precise parts from lighter gauge metals. Plans for 1987 include the installation of a hydraulic leveling system

for the box-to-chassis fixture.

At the end of 1986, the van schedule was full through mid-June of 1987, with some orders scheduled as far out as September, 1987. Production is expected to increase in 1987 since a partial crew has been added to a second shift in the van line.

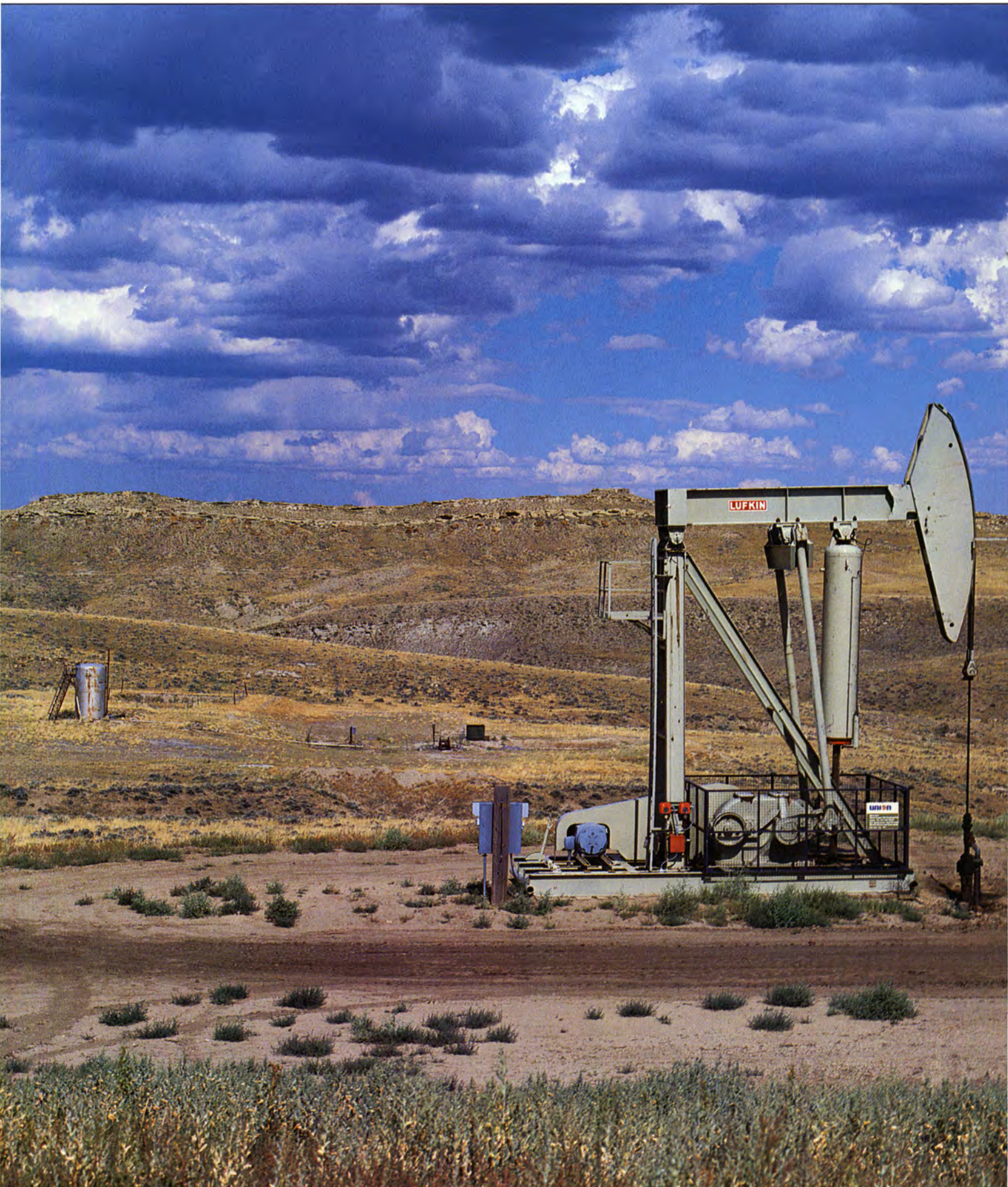
Demand for trailers is expected to remain high in 1987, according to predictions by national trailer associations. With all areas working toward increased efficiency and with the continuing installation of computer technology to help ensure greater productivity, the Trailer Division aggressively will seek its share of the trailer market in 1987.

Opposite: Newly designed steel dump trailer is of lightweight design but tough in endurance.

Below: WALMART, Inc. a new customer for the Trailer Division, placed orders for several hundred vans for delivery in 1986 and 1987.



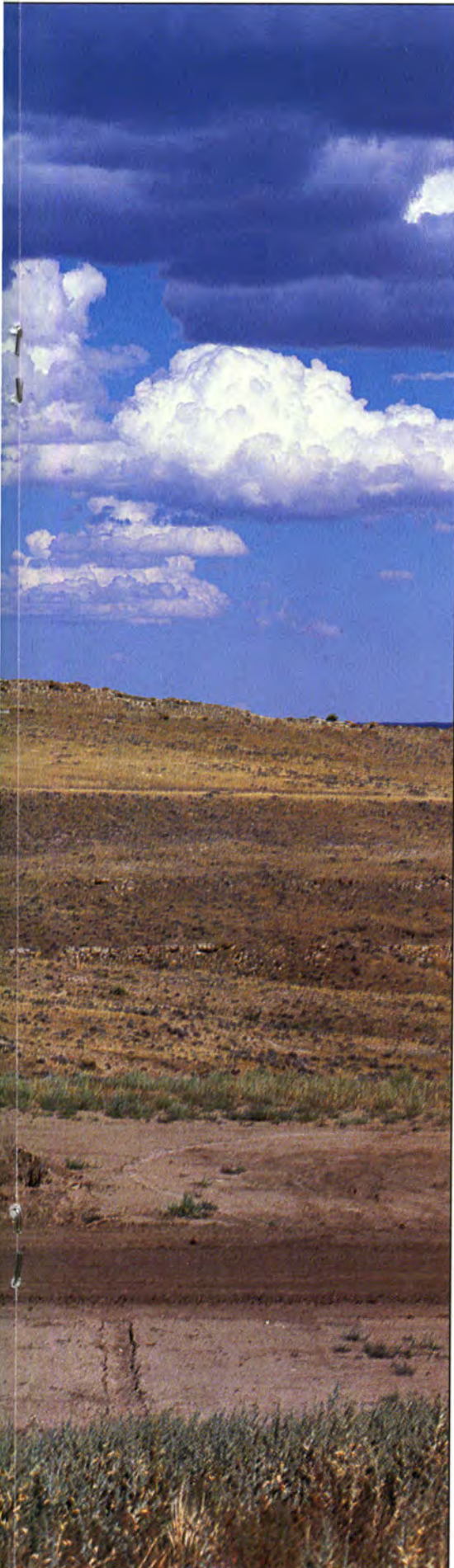




FINANCIAL REVIEW & FINANCIAL STATEMENTS

Index

- 14 Financial Review
- 16 Business Segment Information
- 17 Management's Analysis of
Operating Results and
Financial Condition
- 18 Consolidated Balance Sheet
- 19 Consolidated Statement of
Earnings
- 19 Consolidated Statement
of Stockholders' Equity
- 20 Consolidated Statement of
Changes in Financial Position
- 21 Notes to Consolidated
Financial Statements
- 24 Report of Independent Public
Accountants



From the depths of the earth beneath Natrona County,
Wyoming, a LUFKIN air-balanced unit lifts its oil.

FINANCIAL REVIEW

Description of Business

The Company was incorporated under the laws of Texas on March 4, 1902 and has since that date maintained its principal office and manufacturing facilities in Lufkin, Texas. The Company's operations are divided into three divisions, the Machinery Division, Trailer Division and Industrial Supplies Division, which correspond to the Company's principal industry segments.

Machinery Division

The Company's Machinery Division designs, manufactures, sells, and services various types of oilfield pumping units as well as industrial and marine gears. Lufkin manufactures four basic types of pumping units: an air balanced unit; a beam balanced unit; a crank balanced unit; and a Mark II Unitorque unit. The basic differences between the four types relate to the counterbalancing system. The depth of a well and the desired fluid production determine the type of counterbalancing configuration that is required. There are numerous sizes and combinations of Lufkin oilfield pumping units within the four basic types. The Company's gears (speed increasers and reducers) are designed, manufactured, and sold primarily for use in marine propulsion units and for use in conjunction with machinery in heavy industries such as the steel, rubber, paper and sugar industries. The Company produces numerous sizes and combinations of gears.

The Company manufactures most of the component parts used in its products and purchases the raw materials and outside manufactured parts from a variety of suppliers on an order basis. The inventory of the Machinery Division consists primarily of raw materials and component parts which are generally assembled into finished products to fill specific customer orders. These finished products are sold by the division's own employees directly to the domestic petroleum, manufacturing and ship-building industries.

Oilfield pumping units are the Company's primary products sold in export. These sales, other than to Canada, are made principally through foreign sales representatives, licensees and distributors. During 1986, foreign sales accounted for approximately 18 percent of the Company's total net sales. While foreign sales are generally more profitable, they are subject to the risk of fluctuations in

foreign import duties and taxes.

The domestic and international markets for the products of the Company's Machinery Division are highly competitive with price, quality and the speed of delivery being important factors. While the Company believes that it is one of the larger manufacturers of sucker rod pumping units in the United States, manufacturers of other types of units (submersibles and hydraulics) have a significant share of the total pumping unit market. The Company does not believe it is a significant factor in the gear market.

Trailer Division

The Company designs, manufactures, sells and services a variety of van, flatbed, and dump trailers, ranging in length from 24 to 50 feet and having capacities up to 75,000 pounds in flatbeds, 60,000 pounds in vans, and 30 cubic yards in dump trailers. Manufacturing operations are keyed mainly to specific customer orders.

The Trailer Division is also involved in repairing and selling used trailers which the Company receives in connection with the sale of its new trailers. The Company has trailer sales and service facilities in Atlanta, Georgia; Oklahoma City, Oklahoma; Memphis, Tennessee; and Lufkin, Dallas, San Antonio, Houston and Lubbock, Texas.

The Company uses a sales force of approximately 30 employees to distribute its trailers, primarily in the South. The Company also markets trailers through dealers. The Company's trailers are sold to a large number of customers, including trucking concerns operating nationally.

The truck trailer market is extremely competitive and the Company's products compete directly with those of other manufacturers, a number of which are larger and have greater resources than the Company. Price, quality, speed of delivery, and financing are primary competitive factors. The Company does not believe it is a significant factor in the market for truck trailers either in the South or nationally.

Industrial Supplies Division

The Industrial Supplies Division is essentially a wholesale supplier of heavy hardware items, plumbing fixtures, pole line hardware, and miscellaneous industrial items.

The division's sales are made at the Company's facilities in Lufkin and through five salesmen. Sales are primarily in the East Texas area and the division is not a substantial factor in the markets in which it competes.

FINANCIAL REVIEW

General Information

Properties. The Company's major manufacturing facilities are located in and near Lufkin and are owned in fee.

Machinery Division—The Machinery Division is located on approximately 150 acres and includes a foundry, machine shop, structural shops, assembly shops and warehouses. The Company also has a plant in Nisku, Canada which produces structural parts for pumping units. These parts are then assembled with parts shipped from Lufkin and are delivered to the Company's Canadian customers.

Trailer Division—The Company's trailer manufacturing facilities are located on a 60-acre portion of a 400-acre tract of land owned in fee by the Company and consist of one large building with a floor area of approximately eight acres. The plant operations are highly automated and consist principally of fabrication, welding and assembly activities.

Industrial Supplies Division—The Industrial Supplies Division has one warehouse which is located in Lufkin and contains approximately 120,000 square feet. A portion of this space is used for administrative operations.

Employees. The Company employs approximately 1,700 people, of whom approximately 1,100 are hourly paid. The Company has an open shop contract with three labor unions, all members of the AFL-CIO, which runs to October 1, 1988. The Company considers employee relations to be satisfactory.

Information on Voting Stock

There is no active market in the Company's common stock. As of February, 1987, the Company had approximately 1,100 record holders of its common stock.

Lufkin has paid cash dividends for 47 consecutive years. Total dividend payments were \$17,113,000 in 1986 and \$18,911,000 in 1985.

Quarterly Financial Data

In millions, except per share data	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
1986				
Net sales	\$42.5	\$30.9	\$24.3	\$32.7
Gross income	6.1	—	.1	1.7**
Net earnings	2.0	(1.2)	.3	2.8**
Earnings per share	1.16	(.68)	(.17)	1.96**
Dividends per share	3.00	3.00	2.00	2.00*
1985				
Net sales	\$57.3	\$61.4	\$58.4	\$64.8
Gross income	11.8	14.5	12.8	19.3**
Net earnings	5.3	6.1	5.8	11.4**
Earnings per share	3.11	3.54	3.39	6.60**
Dividends per share	2.75	2.75	2.75	2.75

*Dividend distributed on January 2, 1987 to stockholders of record on December 1, 1986.

**A liquidation of LIFO inventories occurring during the fourth quarters of 1986 and 1985 resulted in an increase in gross income during the quarter.

Additional Financial Information

Shareholders may obtain additional financial information for the year ended December 31, 1986 from the Company's Form 10-K Report filed with the Securities and Exchange Commission. A copy of such report may be obtained without charge by written request to The Secretary, Lufkin Industries, Inc., P.O. Box 849, Lufkin, Texas 75901.

This report is presented for the general information of the shareholders and not in connection with the sale or offer to sell or solicitation of any offer to buy any securities nor is it intended as a representation by the Company of the value of any of its securities.

BUSINESS SEGMENT INFORMATION

(In thousands of dollars)	1986	1985	1984
Net sales:			
Machinery Division			
Pumping units	\$ 51,744	\$152,588	\$168,070
Gears	19,353	21,224	21,043
Trailer Division	52,878	61,349	61,708
Industrial Supplies Division	6,467	6,733	7,185
Total net sales	<u>130,442</u>	<u>241,894</u>	<u>258,006</u>
Operating income (loss):			
Machinery Division	(8,828)	34,304	42,154
Trailer Division	(254)	4,051	4,827
Industrial Supplies Division	(280)	(408)	62
Total operating income (loss)	<u>(9,362)</u>	<u>37,947</u>	<u>47,043</u>
Assets:			
Machinery Division	110,537	131,342	141,336
Trailer Division	48,896	47,325	45,340
Industrial Supplies Division	4,441	5,093	4,899
General corporate assets	108,737	108,711	93,559
Total assets	<u>272,611</u>	<u>292,471</u>	<u>285,134</u>
Capital expenditures:			
Machinery Division	6,177	10,571	9,349
Trailer Division	1,269	742	926
Industrial Supplies Division	19	385	40
General corporate	(98)	1,626	2,314
Total capital expenditures	<u>7,367</u>	<u>13,324</u>	<u>12,629</u>
Depreciation:			
Machinery Division	8,848	8,144	7,604
Trailer Division	616	529	462
Industrial Supplies Division	117	112	113
General corporate	951	956	699
Total depreciation	<u>10,532</u>	<u>9,741</u>	<u>8,878</u>
Net sales by geographic region:			
United States	107,101	203,901	213,058
Canada	9,062	17,334	22,339
Latin America	6,122	10,258	13,037
Other regions	8,157	10,401	9,572
Total net sales	<u>\$130,442</u>	<u>\$241,894</u>	<u>\$258,006</u>

MANAGEMENT'S ANALYSIS OF OPERATING RESULTS AND FINANCIAL CONDITION

Operating Results

Net sales as well as earnings were down significantly in 1986. Sales for 1986 were \$130.4 million compared to \$241.9 million in 1985, a decrease of 46%. Sales for 1985 had decreased 6% from 1984 sales totaling \$258.0 million. Net earnings decreased 86% from \$28.6 million in 1985 to \$3.9 million in 1986. This followed a 30% decrease in net earnings in 1985. Net sales in each of the Company's product lines decreased in 1986 with the largest decreases being the Machinery Division's pumping unit products which decreased 66% during 1986 and the Trailer Division's products which decreased 14% in 1986.

The Company's pumping unit markets were adversely affected by the instability in the market price of oil and the resulting decline in drilling activity during 1986. This reduction in drilling activity caused the number of pumping units shipped during 1986 to decrease 65% after decreasing 17% in 1985. In addition, the average unit size shipped decreased 9% in 1986 after increasing 13% in 1985.

Due to the uncertainty of oil prices and the supply/demand imbalance of oil, the Company is unsure of prospects for 1987 and beyond. Improvement in the Company's sales of pumping units is dependent on improved drilling activity which is conditional on the recovery in demand for oil and stable oil prices.

The Machinery Division reported an operating loss of \$8.8 million for 1986 compared to an operating profit of \$34.3 million in 1985 and \$42.2 million in 1984. The loss in 1986 resulted from excess manufacturing capacity and price pressure on pumping unit products.

The Trailer Division's sales decreased 14% from \$61.3 million in 1985 to \$52.9 million in 1986. Trailer sales in 1984 were a record at \$61.7 million. While the volume of trailers sold decreased 3% in 1986 the major cause for the 14% decrease in net sales was the downward price pressure resulting from decreased total demand for trailers. Although the demand for the Company's trailers has remained high, the decreased demand for trailers in the industry has resulted in a decrease in the selling price of trailers.

After allocation of corporate expenses, the Trailer Division reported an operating loss of \$.3 million in 1986, compared to operating profits of \$4.1 million in 1985 and \$4.8 million in 1984. The net operating loss in 1986 was caused by the increased competitive conditions in the trailer industry and the resulting price reductions.

The Trailer Division had a backlog of approximately \$27.5 million in sales orders at the beginning of 1987. The Company feels that trailer sales will continue to be strong throughout 1987.

Interest income increased 11% in 1986 primarily as the result of a change in the Company's method of recognizing interest income on its installment notes and contracts receivable during 1986. The increase in other expense in

1986 was primarily from a currency exchange loss on the payment of a dividend from the Company's Canadian subsidiary. The Company has an income tax credit of \$1.9 million for 1986 as a result of a large portion of interest income during the year not being subject to Federal income taxes.

The effects of the Tax Reform Act of 1986 (the Act) on the Company's future results of operations and financial position are difficult to quantify. In terms of the provision for taxes currently payable, the net effect of the Act will not be significant. With respect to the provision for deferred taxes, under existing generally accepted accounting principles, timing differences arising after the Act's enactment will result in lower future years' deferred tax provisions; however, the effects of the lower rates on existing deferred taxes are not expected to significantly impact future reported results. This is because existing accounting principles require that deferred taxes be provided at the tax rate in effect for the year in which the income or expense item enters into income on a financial reporting basis. Subsequent changes in tax rates and laws do not result in an adjustment of existing deferred tax balances until the income or expense item enters into taxable income. Given the present accounting rules and the expectation of continued investment in capital assets, it is unlikely that the effects of the lower tax rates on existing deferred tax balances will significantly impact future reported results. However, if the accounting rules for income taxes are changed, as currently proposed, then the decrease in tax rates will reduce existing deferred tax balances at the date the new rules are adopted.

Liquidity and Capital Resources

At December 31, 1986, the Company had working capital of \$103,394,000 as compared to \$126,999,000 at December 31, 1985 and \$113,274,000 at December 31, 1984.

The Company believes that existing working capital is sufficient to satisfy its 1987 requirements. In recent years, the expansion of the Company's facilities has been financed with internally generated funds and the Company plans financing any expansion and improvements of its facilities in this manner.

In assessing the Company's liquidity, the impact of the Act has been considered, particularly the provisions that (1) repeal the investment tax credit, (2) modify inventory capitalization rules, (3) alter depreciation schedules, (4) provide for an alternative minimum tax and (5) lower the overall corporate income tax rate. The lowering of the overall corporate tax rate affects not only taxes that will be currently payable in future years but also the amount of deferred taxes provided through December 31, 1986 that actually will be payable in future years. Although the interaction of the tax law changes is difficult to determine, it is not expected that these changes will significantly affect the Company's cash flow.

CONSOLIDATED BALANCE SHEET

December 31, 1986 and 1985
(Thousands of dollars)

Assets	1986	1985
Current assets:		
Cash	\$ 1,927	\$ 3,539
Temporary investments	42,031	57,013
Accounts receivable, less allowance of \$225,000	16,264	33,863
Refundable income taxes	4,908	—
Installment notes and contracts receivable, less allowance of \$75,000	29,222	28,330
Inventories	21,048	22,111
Total current assets	115,400	144,856
Property, plant and equipment:		
Land	8,055	7,947
Buildings	48,954	48,546
Machinery and equipment	124,522	118,542
	181,531	175,035
Less accumulated depreciation	75,373	65,712
Net property, plant and equipment	106,158	109,323
Investments in marketable securities	50,693	37,987
Other assets	360	305
	<u>\$272,611</u>	<u>\$292,471</u>

Liabilities and Stockholders' Equity

Current liabilities:		
Accounts payable	\$ 5,825	\$ 8,080
Accrued liabilities:		
Payrolls	1,074	1,544
Contributions to pension plans	—	1,869
Taxes	1,689	1,636
Dividends declared	3,418	4,728
Total current liabilities	12,006	17,857
Deferred income taxes	21,875	20,421
Stockholders' equity:		
Common stock, par \$1 per share; 4,000,000 shares authorized; 1,708,024 issued in 1986 and 1,719,210 in 1985	1,708	1,719
Capital in excess of par	15,454	15,555
Retained earnings	221,568	236,919
Total stockholders' equity	238,730	254,193
	<u>\$272,611</u>	<u>\$292,471</u>

See notes to consolidated financial statements.

CONSOLIDATED STATEMENT OF EARNINGS

Years ended December 31, 1986, 1985 and 1984
(Thousands of dollars)

	1986	1985	1984
Net sales	\$130,442	\$241,894	\$258,006
Cost and expenses:			
Cost of sales	122,566	183,511	192,885
Selling, general and administrative expenses	17,238	20,436	18,078
	<u>139,804</u>	<u>203,947</u>	<u>210,963</u>
Operating income (loss)	(9,362)	37,947	47,043
Other income (expense):			
Interest income	12,085	10,888	11,275
Interest expense	(84)	(236)	(267)
Other, net	(683)	(329)	(16)
Earnings before income taxes	1,956	48,270	58,035
Income taxes	(1,931)	19,655	17,062
Net earnings	<u>\$ 3,887</u>	<u>\$ 28,615</u>	<u>\$ 40,973</u>
Earnings per share	<u>\$ 2.27</u>	<u>\$ 16.64</u>	<u>\$ 23.83</u>

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

Years Ended December 31, 1986, 1985 and 1984
(Thousands of dollars)

(Thousands of dollars)	<u>Common Stock</u>		Capital	
	<u>Shares</u>	<u>Amount</u>	In Excess of Par	Retained Earnings
Balance December 31, 1983.....	1,719,210	\$1,719	\$15,555	\$203,434
Net earnings				40,973
Cash dividends, \$10.00 per share				(17,192)
Balance December 31, 1984.....	1,719,210	1,719	15,555	227,215
Net earnings				28,615
Cash dividends, \$11.00 per share				(18,911)
Balance December 31, 1985.....	1,719,210	1,719	15,555	236,919
Net earnings				3,887
Cash dividends, \$10.00 per share				(17,113)
Stock purchased and retired	(11,186)	(11)	(101)	(2,125)
Balance December 31, 1986.....	1,708,024	\$1,708	\$15,454	\$221,568

See notes to consolidated financial statements.

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

Years ended December 31, 1986, 1985 and 1984
(Thousands of dollars)

	1986	1985	1984
Source of funds:			
From operations:			
Net earnings	\$ 3,887	\$ 28,615	\$ 40,973
Expenses not currently requiring outlay of working capital:			
Depreciation	10,532	9,741	8,878
Deferred income taxes	<u>1,454</u>	<u>3,799</u>	<u>(2,243)</u>
Funds generated from operations	15,873	42,155	47,608
Decrease in marketable securities and other assets	<u>—</u>	<u>3,805</u>	<u>2,742</u>
Total funds provided	<u>15,873</u>	<u>45,960</u>	<u>50,350</u>
Use of funds:			
Net additions to property, plant and equipment	7,367	13,324	12,629
Dividends	17,113	18,911	17,192
Reduction in long-term debt	—	—	2,000
Stock purchased and retired	2,237	—	—
Increase in marketable securities and other assets	<u>12,761</u>	<u>—</u>	<u>—</u>
Total funds used	39,478	32,235	31,821
Increase (decrease) in working capital	<u>\$(23,605)</u>	<u>\$ 13,725</u>	<u>\$ 18,529</u>
Working capital increase (decrease) resulted from changes in:			
Cash	\$ (1,612)	\$ (269)	\$ 339
Temporary investments	(14,982)	18,557	(4,560)
Accounts receivable	(17,599)	(9,818)	13,461
Refundable income taxes	4,908	—	—
Installment notes and contracts receivable	892	4,155	7,726
Inventories	(1,063)	(5,066)	1,094
Accounts payable	2,255	3,956	(5,249)
Accrued liabilities	<u>3,596</u>	<u>2,210</u>	<u>5,718</u>
Increase (decrease) in working capital	<u>\$(23,605)</u>	<u>\$ 13,725</u>	<u>\$ 18,529</u>

See notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) Summary of major accounting policies

Principles of consolidation: The consolidated financial statements include the accounts of the Company and its subsidiaries after elimination of all significant intercompany accounts and transactions.

Temporary investments and investments in marketable securities: In the accompanying balance sheet, temporary investments are carried at cost, which approximates market. The investment in marketable securities consisting of corporate and tax exempt bonds, government securities, common and preferred stock and guaranteed investment contracts is carried at cost and had a market value of \$51,209,000 and \$38,216,000 at December 31, 1986 and 1985, respectively.

Installment notes and contracts receivable: A portion of the Company's sales is made on notes and conditional sales contracts which are payable on an installment basis over a period generally from three to five years. The profit from such sales is included in income at the time of sale for financial reporting purposes; however, for tax purposes such profit is recognized as installments are collected. The amounts due after one year (\$19,515,000 at December 31, 1986 and \$18,813,000 at December 31, 1985) are included in current assets in accordance with trade practice. Prior to 1986, the Company utilized the straight-line method of recognizing interest income on installment receivables. During 1986 the Company adopted a declining balance method of recognizing interest income and recorded the cumulative effect of the change (\$2,000,000) as an increase in interest income.

Inventories: The Company uses the last-in, first-out (LIFO) method of determining inventory cost, which does not exceed market, for substantially all inventories. Inventory costs include material, labor and factory overhead.

Property, plant and equipment: The Company records investments in these assets at cost. Improvements are capitalized, while repair and maintenance costs are charged to operations as incurred. Gains or losses realized on the sale or retirement of these assets are reflected in income. The Company uses the straight-line depreciation method for financial reporting and accelerated methods for tax purposes.

Income taxes: The Company provides for United States taxes that may ultimately be payable on all undistributed foreign earnings. Provision is also made in the financial statements for the deferred taxes applicable to depreciation, income on installment notes and contracts receivable and other timing differences between financial and tax reporting methods. Current recognition is given in the statement of earnings to tax benefits resulting from investment tax credits using the flow-through method.

Earnings per share: Earnings per share amounts are based on the weighted average number of shares of common stock outstanding during the period.

(2) Retirement plans

The Company and its subsidiaries have retirement plans covering substantially all employees. The total pension expense was \$19,000 in 1986, \$1,890,000 in 1985 and \$4,613,000 in 1984. The amount provided each year for pension expense is paid into pension trust funds. The total unamortized prior service costs at January 1, 1986, the date of the latest actuarial valuation, was estimated to be \$1,546,000.

A comparison of accumulated plan benefits, calculated using an estimated rate of return of 7.0%, and net assets for the plans are as follows:

	(In thousands)	
	January 1	
	1986	1985
Actuarial present value of accumulated plan benefits		
Vested	\$43,814	\$36,521
Nonvested	2,002	1,780
	<u>\$45,816</u>	<u>\$38,301</u>
Net assets available for benefits	<u>\$68,819</u>	<u>\$61,401</u>

NOTES TO FINANCIAL STATEMENTS

(3) Income taxes

The income tax provision (credit) for 1986, 1985 and 1984 consisted of the following:

	(Thousands of dollars)		
	1986	1985	1984
Amounts currently payable	<u>\$ (3,385)</u>	<u>\$15,856</u>	<u>\$19,305</u>
Amounts deferred	<u>1,454</u>	<u>3,799</u>	<u>(2,243)</u>
	<u>\$ (1,931)</u>	<u>\$19,655</u>	<u>\$17,062</u>

A reconciliation of the provision for income taxes to the United States tax rate of 46% of earnings before income taxes is as follows:

	(Thousands of dollars)		
	1986	1985	1984
Taxes computed at statutory rate	\$ 900	\$22,204	\$26,696
Investment tax credits	(693)	(959)	(483)
Taxes previously provided on DISC*	—	—	(8,397)
Tax-exempt interest	(1,665)	—	—
Other, net	(473)	(1,590)	(754)
Actual provision	<u>\$ (1,931)</u>	<u>\$19,655</u>	<u>\$17,062</u>

The Company provides deferred taxes for timing differences between financial and taxable income as follows:

	(Thousands of dollars)		
	1986	1985	1984
Excess of tax depreciation over book depreciation	\$ 2,054	\$ 3,486	\$ 3,207
DISC earnings not currently subject to tax	(231)	(231)	(6,087)
Income on installment notes	(369)	544	637
	<u>\$ 1,454</u>	<u>\$ 3,799</u>	<u>\$ (2,243)</u>

*In prior years, the Company provided deferred taxes on the undistributed earnings of its DISC subsidiary. The Tax Reform Act of 1984 treats these undistributed earnings as previously taxed income, and therefore, they escape tax permanently.

(4) Inventories

Inventories used in determining cost of sales were as follows:

	(Thousands of dollars)			
	1986	1985	1984	1983
Finished goods	<u>6,205</u>	<u>\$ 5,865</u>	<u>\$ 5,670</u>	<u>\$ 5,054</u>
Work in process	<u>7,864</u>	<u>9,085</u>	<u>11,597</u>	<u>10,391</u>
Raw material	<u>6,979</u>	<u>7,161</u>	<u>9,910</u>	<u>10,638</u>
	<u>\$21,048</u>	<u>\$22,111</u>	<u>\$27,177</u>	<u>\$26,083</u>

Had the FIFO method been used in determining inventory values, inventories would have been \$27,347,000, \$28,424,000, \$30,936,000 and \$29,693,000 higher at December 31, 1986, 1985, 1984 and 1983, respectively.

During 1986 and 1985, inventory quantities were reduced. These reductions resulted in a liquidation of LIFO inventory quantities carried at lower costs prevailing in prior years. The effect of these liquidations increased net earnings by approximately \$2,162,000 or \$1.26 per share in 1986 and \$2,409,000 or \$1.40 per share in 1985.

(5) Supplementary income statement information

The following costs and expenses were charged to income during 1986, 1985, and 1984:

	(Thousands of dollars)		
	1986	1985	1984
Maintenance and repairs	<u>\$3,383</u>	<u>\$5,816</u>	<u>\$5,047</u>
Depreciation	<u>10,532</u>	<u>9,741</u>	<u>8,878</u>

(6) Business segment information

Information concerning the Company's various business segments is included on Page 16 of this report.

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Stockholders of Lufkin Industries, Inc.

We have examined the consolidated balance sheet of Lufkin Industries, Inc. (a Texas corporation), and subsidiaries as of December 31, 1986 and 1985 and the related consolidated statements of earnings, stockholders' equity and changes in financial position for each of the three years in the period ended December 31, 1986. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying consolidated financial statements present fairly the financial position of Lufkin Industries, Inc., and subsidiaries as of December 31, 1986 and 1985, and the results of their operations and the changes in their financial position for each of the three years in the period ended December 31, 1986, in conformity with generally accepted accounting principles applied on a consistent basis.

ARTHUR ANDERSEN & CO.

Houston, Texas
February 16, 1987

DIRECTORS AND OFFICERS

Board of Directors

*S.W. Henderson, Jr., Manager of his own investments

S.W. Henderson, III, President of Lufkin Federal Savings & Loan

J.G. Kurth, Manager of his own investments

*M.E. Kurth, Jr., Manager of his own investments

W.T. Little, Management Consultant

*R.L. Poland, Retired Chairman of the Board and Chief Executive Officer

*F.B. Stevenson, President and Chief Executive Officer

H.J. Trout, Jr., District Sales Manager, Lufkin Industries, Inc.

*W.W. Trout, Jr., Vice President

*J.L. Wiener, Partner, Wiener, Weiss, Madison & Howell (law firm)

J.L. Wiener, Jr., Partner, Wiener, Weiss, Madison & Howell (law firm)

T.E. Wiener, Principal, Sarnier, Franklin, Grodinsky, Margulies & Huntington (law firm)

*Member Executive Committee

Officers

F.B. Stevenson, President, Chief Executive Officer

H.J. Green, Vice President

J.R. Partridge, Vice President

M.A. Penn, Vice President

E.G. Pittman, Vice President

J.E. Riggs, Vice President

W.W. Trout, Jr., Vice President

E.L. Watts, Vice President

C.J. Haley, Jr., Secretary-Treasurer

R.E. Myers, Jr., Assistant Secretary

J.B. Massingill, Assistant Treasurer

Opposite: J.B. Hunt continued to be LUFKIN's largest trailer customer accounting for 35 percent of total production in the Trailer Division.





INDUSTRIES, INC.

P.O. Box 849 / Lufkin, Texas 75901
