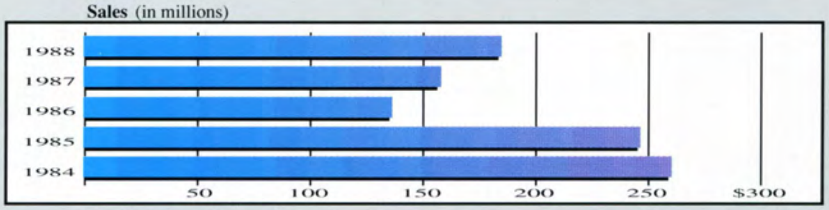
Annual Report 1988

LUFKIN

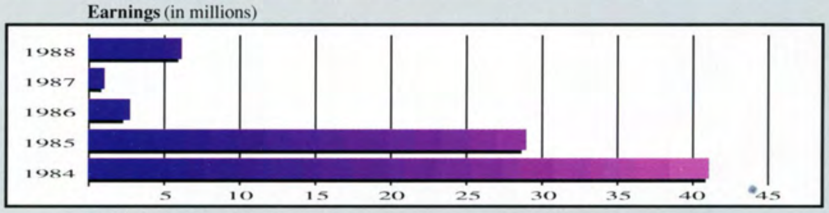
Financial Highlights

(In thousands of dollars, except per share data)	**1988**	1987	1986	1985	1984
Net sales	**$181,158**	$158,077	$130,442	$241,894	$258,006
Net earnings					
Earnings before the cumulative effect of the change in accounting for income taxes	**766**	1,066	2,807	28,615	40,973
Cumulative effect of the change in accounting for income taxes	**5,170**	—	—	—	—
	5,936	1,066	2,807	28,615	40,973
Earnings per share					
Earnings before the cumulative effect of the change in accounting for income taxes	**0.45**	0.62	1.64	16.64	23.83
Cumulative effect of the change in accounting for income taxes	**3.03**	—	—	—	—
	3.48	0.62	1.64	16.64	28.83
Total assets	**246,171**	264,483	272,611	292,471	285,134
Cash dividends per share	**7.00**	8.00	10.00	11.00	10.00
Book value per share	**128.78**	132.39	139.77	148.85	142.21

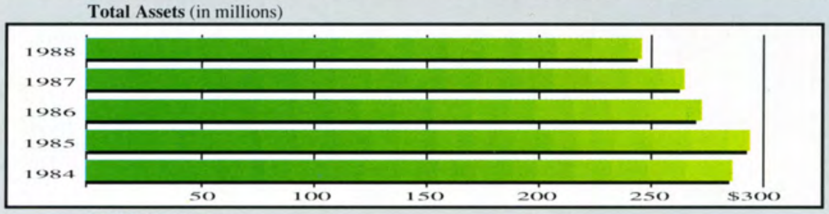
Sales (in millions)



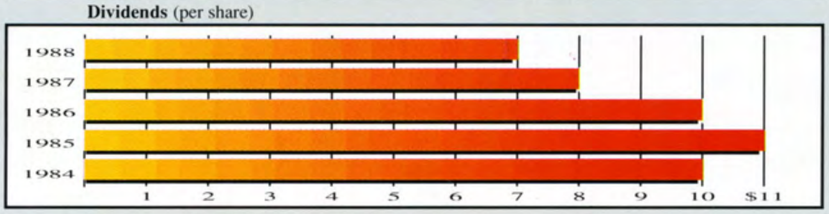
Earnings (in millions)



Total Assets (in millions)



Dividends (per share)



Left: A LUFKIN Mark II Unit works under fair Spring skies near Odessa, Texas.

To Our Shareholders

Sales for your Company increased to $181.2 million in 1988, an increase of approximately 15 percent. Cash flow from operations had a significant improvement also. All Divisions of the Company participated in these increases which indicates hard work and dedication by LUFKIN employees.

During the past year, every operating Division of the Company was severely impacted by highly competitive conditions and increasing costs of materials. The Machinery and Trailer Divisions were hit particularly by increases in the price of steel, bearings and aluminum. In these extremely competitive markets, we were unable to pass on these increases to our customers.

Oil Field Equipment - The drilling rig activity was at a five-year low which limited greatly the market for our pumping units and Sargent motor sales. The price of oil was extremely volatile, and oil imports to the United States increased substantially. The oil field equipment product line, by far the broadest in the industry, has been the primary cash generator of the total Company for a number of years. We continued to improve our product and our services in 1988, and have opened and expanded services areas in the key oil field locations.

Trailer Division - The Trailer Division set record sales in 1988 of $73.5 million. However, operating profitability was affected adversely by a highly competitive market with considerable excess capacity and sharply increased material prices, particularly in aluminum and steel. We have improved and expanded our branch operations and now have nine branch locations throughout the southern part of the country.

Industrial Gears - Industrial gear volume improved considerably in 1988. We keep penetrating new markets, particularly in the high-speed applications. We are improving and increasing our product line as we serve an expanding worldwide market. Our sales force has been increased and we are now shipping industrial gear products throughout the world. We continue to package more horsepower in smaller units, which requires a much higher degree of precision in each part of the unit. We shortened the product cycle, which not only reduces the lead time to the customer, but also reduces the inventory cycle.

Industrial Supplies - Sales of the Industrial Supplies Division totalled $7.9 million in 1988, and its business grew and improved in the regional markets that it serves. The product lines were expanded and service and delivery were improved. In addition to the industrial customers in the East Texas region, the Industrial Supplies Division provides a very important supply service to the manufacturing shops of the Company. Approximately half the sales of this Division were from other areas of the Company. This service allows us to be much more competitive and efficient through out the whole Company.

More Efficient and Competitive - We have a long history of building for the future, and each year we are making LUFKIN leaner, more competitive and a more intensely focused Company. We have expanded our revenue stream by broadening and improving our product lines, and we have reduced our costs by sharp curtailment of expenses and staffing throughout the whole Company. During the past several years, our work force has been cut in half and much shifting of assignments and personnel has taken place. We greatly appreciate the flexibility and "can do" attitude of all LUFKIN employees as they have moved to different jobs to produce different products and to continue to improve our overall operation.

We have sought diligently to create the customer partnerships by which we can build long-term relationships to assure our markets for the future. We believe we have been successful in this.

Outlook - We will continue to face extremely competitive conditions in 1989 in all the markets that we serve. However, we face these challenges with confidence that we will grow and improve our operations despite these competitive environments.

For many years the pumping unit has been the primary product of the Company. We are moving away now from a one-product Company into an organization which is prepared to take advantage of the growth opportunities in the various other markets that we serve. Of course, we will continue to serve and improve our segment of the oil field industry market, but, in addition, we will move aggressively to develop more fully the other markets and broaden the focus of Lufkin Industries.

We have exceptional financial strength and a strong technology base. In addition, we have a group of employees who are unique in their talents, abilities and energies. Their commitment to the values that have made this Company successful will continue to provide the driving force which will assure our success in the future.

F B Stevenson

Frank B. Stevenson
President and Chief
Executive Officer

Right: A LUFKIN Conventional Unit lifts oil from beneath the great expanse of Wyoming.


LUFKIN

Machinery Division

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

This Division manufactures and markets a complete line of oil field sucker rod pumping units in API sizes and stroke lengths. Being the innovator in sucker rod pumping unit design and manufacturing, this Division offers crank-balanced, air-balanced, Mark II, beam-balanced, slant hole, low profile and portable trailer-mounted sucker rod pumping units.

During 1988, the Company introduced a new line of pumping units and designated it the RM Series. This unit employs a new geometry similar to the crank-balanced unit with many of the characteristics of the Mark II line of pumping units. This new series will make it possible for the Company to fill the sucker rod pumping unit needs of the industry better.

The new Roadrunner pumping unit, a portable trailer-mounted sucker rod pumping unit which was introduced in 1987, continued to be highly acceptable as innovative applications have been found within the industry.

In addition to the many standard models and configurations available from LUFKIN's catalog, special designs are available to meet any unusual requirement by the customer.

The Sargent product line, located in Midland, Texas, and acquired by LUFKIN in 1987, is operated as a component of the Machinery Division. It assembles and markets a special line of high slip oil field pumping unit electric motors, sucker rod pumping system controls and in 1987, introduced a solid state pumping unit monitoring system. This system is used to monitor and control the pumping functions either at the well site or at a remote location using radio telemetry. Sargent has continued to pursue the oil field automation market, and its products enjoy the same high quality and customer service reputation as other LUFKIN products.

Pumping unit business remained slow in 1988, with low oil prices causing drilling activity to drop to the lowest level in more than 15 years.

Many of the Company's major customers are able to fill virtually all of their pumping unit requirements from their own surplus of units created from marginal wells which have been plugged.

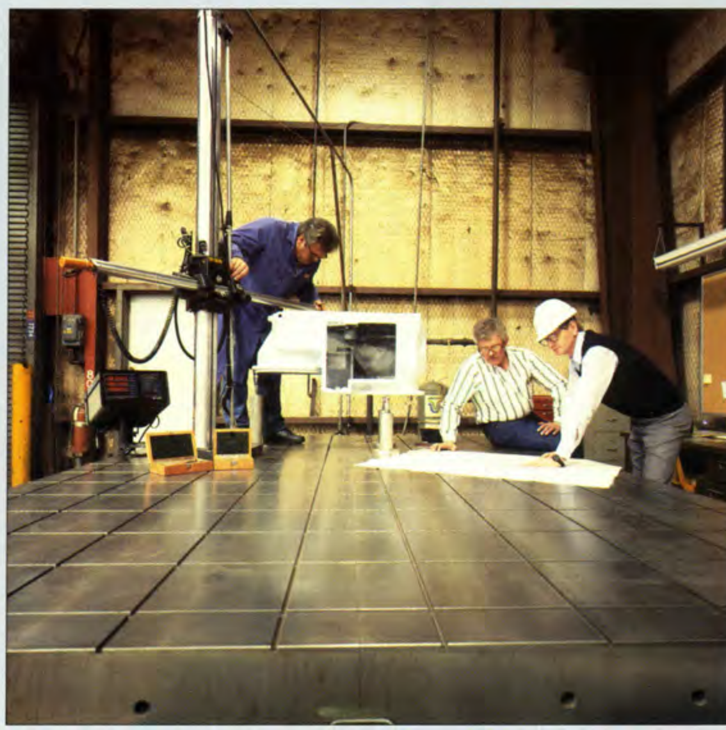
New applications for existing products are researched continuously. One example of this is the use of pumping units for the enhancement of gas recovery from coal seam. Several of these wells come with large volumes of water that must be pumped off to allow the gas to be produced. This coal degasification continues to be strong in the San Juan Basin in northern New Mexico and in the Black Warrior Basin in Alabama.

LUFKIN plans to be quite active in both of these areas in 1989.

Below, left: A Sargent Econo-Pac 2 pumping system control and electric motor is mounted on the rear of a LUFKIN unit in Wyoming. This system monitors and controls pumping functions either at the well site or at a remote location, using radio telemetry.

Below: A coordinate measuring machine was purchased in 1988 to monitor more closely dimensional tolerances required for foundry castings.

Right: A new 30-ton holding furnace was added in foundry operations to meet shorter lead times for a variety of metal specifications.



Machinery Division

Located in Houston, Texas, the international sales group succeeded in increasing sales in international markets by 58 percent over 1987. Pumping units were sold in some 14 foreign countries during 1988. This business is serviced by a network of agents and distributors.

A new pumping unit sales office was opened in Hobbs, New Mexico, to service customers better in southeast New Mexico and northwest Texas.

To strengthen LUFKIN's field service areas, additional service personnel were added in service centers located in Oklahoma City; Casper, Wyoming; Bakersfield, California; and Kilgore and Odessa, Texas. Also, a network of authorized distributors for pumping unit parts was launched outside the service center trade areas.

In addition to oil field equipment, the Machinery Division manufactures a complete line of heavy-duty industrial, marine and special purpose gear units. The Company is considered a leader 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 throughout the world. Gear units are applied in the petrochemical, rubber, paper, sugar, marine propulsion, food processing, plastic, utilities, coal processing industries, and any other industries requiring heavy-duty gear drives. Gear units are considered an engineered product and in the past, they have competed best in the lower volume, special application markets.

The high performance segment of the gear business continued to grow and capital equipment was purchased to fill these requirements. Also, the marine propulsion segment of the business showed signs of activity after being dormant since 1982.

The gear repair business was expanded to cover all makes of gear units and open gearing. The parts and repair segment of the gear business accounted for more than 30 percent of gear sales and should continue to grow.

Efforts were made to develop markets in the standard lines of gear units where higher volume sales and production rates are possible. Also, the Company pursued a much broader range of gear products to include loose gearing and proprietary designs which are sold to customers to be used as a component of their products.

The wide variations in requirements for castings throughout 1988 necessitated flexible responses from the Company's foundries. One of these responses was to alternate cupola melting with arc furnace melting to provide metal requirements at the lowest possible cost.

An additional response was to add another holding furnace to answer customer requests for shorter lead times for a variety of metal specifications.

The Company purchased a coordinate measuring machine to provide increased capabilities to monitor more closely dimensional tolerances required for both LUFKIN and commercial castings. This machine, together with a broadening effort to expand and improve quality controls, resulted in significant improvements in quality and cost reductions in the operations of the foundries.

Many manufacturing methods and process improvements were made in the

Above: A 31,500 horsepower speed-reducer is being tested, fully loaded, on LUFKIN's test equipment.

Left: Large industrial gear housings are manufactured on state-of-the-art computerized numerically controlled machining centers.

foundries during 1988. Point-of-use storage locations, conveyor systems, core elimination and the reduction of many non-value-adding activities improved work flows and reduced lead times and costs.

By utilizing the capital improvements which have been made during recent years, the foundries achieved another record low rate of scrap for pumping units and industrial gear castings.

In the operations of LUFKIN'S foundries, the driving force continues to be a commitment to productivity, quality products and customer service.

In the machine shops, the major emphasis for the past years was to achieve and maintain a profitable operating status while improving the quality and reliability of LUFKIN products to be delivered to the customer on a timely basis.

The manufacturing facilities were improved with heavy emphasis on accuracy and reliability of the machine tools. The integrity of machines was maintained through indepth preventive maintenance, re-manufacturing programs and the purchase of new technologically modern equipment.

During 1988, the linked, flow-through manufacturing cell production areas were enhanced by refining and linking more machining and assembling operations.

Another focus in the machine shops was improvements in the overall industrial gear manufacturing areas, outside commercial products and repairs and service operations. Several machines in the shop were re-manufactured, and an additional precision gear grinder was purchased.

The capacity to test LUFKIN's high speed gear units was expanded to allow more intricate testing of an increased quantity of units as well as the considerably higher horsepower units.

The gear repair business expanded in 1988, due to several factors. Many customers continued to repair gear units rather than purchase new ones. The Company actively pursued the repairs market with staff, equipment and advertising designed to attract that portion of the business.

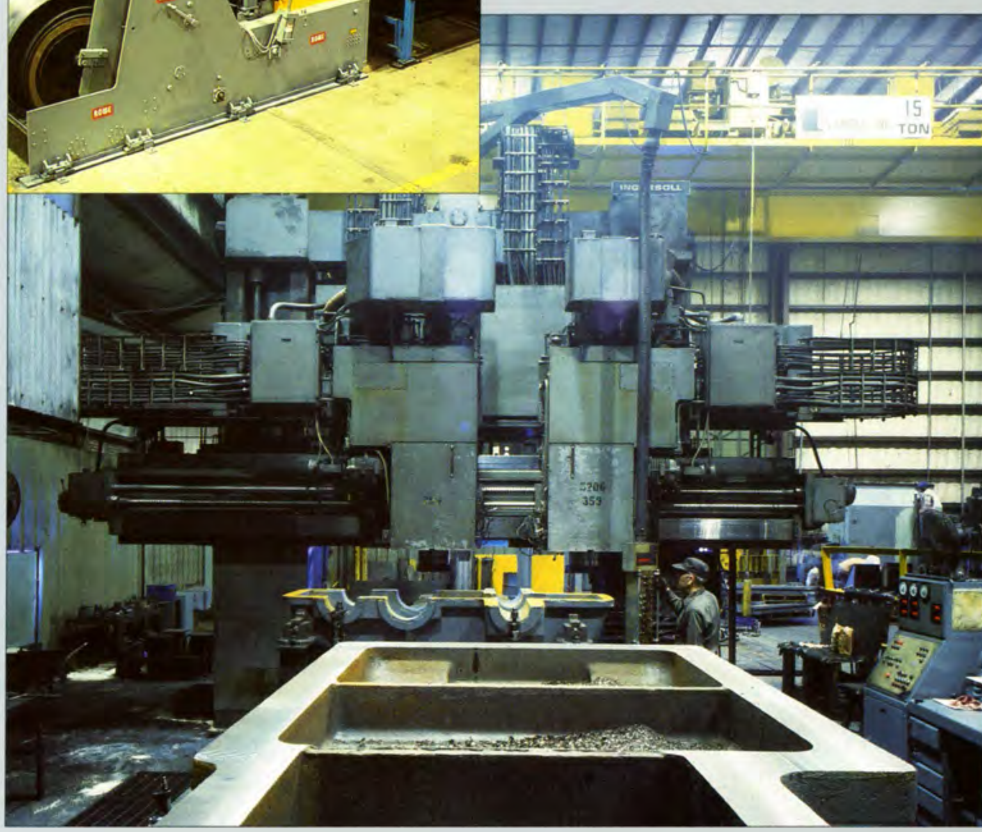
Among the outside commercial products being manufactured are a line of horizontal reciprocal fluid pumps and new products associated with the plastics industry.

The Company's structural fabrications operations include the welding shop and assembly/shipping departments at the Buck Creek plant located seven miles east of the main manufacturing complex in Lufkin, and the heavy weldment shop at the main downtown plant.

The welding shop and assembly/shipping departments are devoted primarily to pumping units while the heavy weldment shop is concerned with industrial gear housing fabrication as well as dump and drop-frame trailers.

The "factory of the future" concept came a step closer in 1988 in the Machinery Division. With the completion of a truly integrated CAD/CAM manufacturing system in the structural fabrication operations, about 80 percent of the Machinery Division is now operating under this system.

The CAD/CAM manufacturing system begins in the design engineering department where a component of a pumping unit is created at a computer-aided-design workstation (CAD). That design is immediately transmitted



Above: A decoiler machine in the structural fabrications operations flattens uncoiling plate steel as it feeds to the plasma arc cutter to make belt covers.

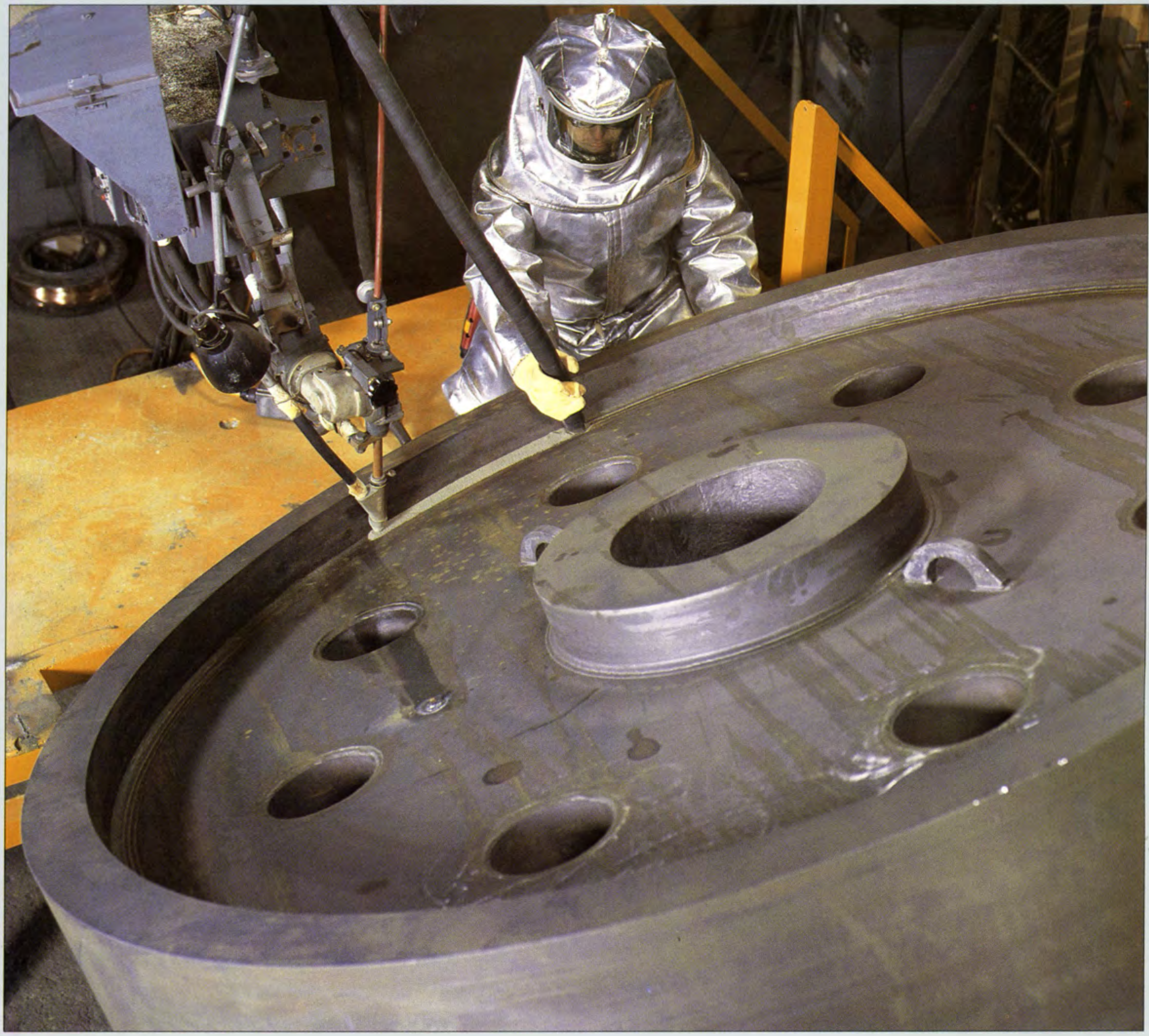
Right: This precision machine mills with extreme accuracy flat surfaces on housings for industrial gears and large pumping unit gears, and on special milling orders from outside commercial customers.

electronically (via phone line) to the manufacturing engineering workstation where machine instructions are added to the part geometry (CAM: computer-aided-manufacturing). Next, the part is transmitted via fiber optic cable to the computer-controlled machine (CNC) in the factory which will manufacture the part.

Neither drawings nor blueprints need be made and transported, and machine tapes are not required. Parts are manufactured exactly as designed, since all traditional intermediate steps with their delays and opportunities for error have been eliminated.

The ability to provide this immediate response to customers further improves the Company's competitive position.

This gear blank, eight feet, four and one-half inches in diameter, is being sub-arc welded at temperatures ranging from 500° to 600° F. A no-spark process, the welding machine lays down a bead of sand under which the welding is done. An operator, protected by an air-conditioned suit, vacuums the sand after the weld is made. Eventually, this giant low-speed gear unit was shipped to a rubber tire manufacturing plant.



Industrial Supplies Division

The Industrial Supplies Division recorded a 15 percent increase in sales during 1988, for a total of $7.9 million, compared to $6.9 million in 1987. The largest gain in sales was from outside the Company from industrial and commercial customers in the paper mill, timber, and foundry industries, public utilities and other businesses.

Other Divisions of Lufkin Industries purchased some $4 million in supplies during 1988, compared to $3.3 million in 1987.

Serving customers within a radius of about 150 miles of Lufkin, the Industrial Supplies Division distributes three basic product lines. One of these lines is industrial supplies, such as valves, welding supplies, wirerope, cut-off saws, grinding wheels, cutting tools and hand tools.

Another line is plumbing supplies, such as American Standard fixtures and trim, cast iron and pvc pipe and fittings, water heaters and water coolers.

The third line is pole-line hardware, such as crossarms, ground rods, insulators and cut-outs used in the electric utility industry.

With about $3 million in inventory, the Supplies Division warehouses some 18,000 line items in its 126,000-foot warehouse in Lufkin and in a small warehouse in Jasper, Texas.

In 1988, the Industrial Supplies Division emphasized two specific areas, the power transmission products and the Bath & Kitchen Showplace, a display area outfitted with plumbing fixtures.

Each of these targeted areas experienced excellent growth, with power transmission sales increasing an amazing 94 percent to about $652,000, compared with sales of approximately $336,000 in 1987. Sales in the Bath & Kitchen Showplace increased from $138,000 to approximately $199,000, a 43 percent increase in 1988.

During 1989, this Division will target the area of welding equipment and supplies, while continuing to emphasize sales in the power transmission and Bath & Kitchen Showplace areas.

The Bath & Kitchen Showplace is a display area outfitted with plumbing fixtures.

Trailer Division

Another year of record sales was achieved by the Trailer Division in 1988, reaching $73.5 million. This was a 10 percent increase over sales of $66.5 million in 1987. Trailer sales in 1986 were $52.9 million.

New trailer sales were considerably higher with 5,292 units sold in 1988, compared to 4,700 units sold in 1987. Used trailer sales for 1988 were 466, down from 707 units in 1987. This decrease was caused by less inventory.

Several major projects neared completion in 1988. The computer-aided-design and computer-aided-manufacture (CAD/CAM) system installed during 1987 became fully functional in 1988, with more than 90 percent of production drawings being processed on this system. In addition, direct machine tool programming from CAD-generated drawings became a reality.

The ability to program production machines directly from CAD drawings resulted in an improvement in the design of the popular FL-75 flat-bed trailer. This design improvement resulted in rating increases of up to 40 percent on some versions with no increase in the weight of the trailer.

Another project was scheduled for completion in 1988, but was delayed until mid-1989. This was the certification of van trailers to be used "piggy back" on the railroads. The delay was caused by changes made by the American Association of Railroads in its requirements. Because these changes were more strenuous, new designs were necessary for certain sub-assemblies. Certification of these new sub-assemblies is continuing and final certification should be completed during the first half of 1989.

In order to determine the functionality of some new products available to the trailer industry, about 70 LUFKIN trailers were put in a testing program. Some were put into use in commercial fleets and some in the Company's own transportation department to evaluate such things as anti-lock brake systems, fiberglass composite springs, sealing components, light-weight landing gears as well as many more innovative products.

One prototype van trailer, the first of its type in the industry, was constructed utilizing wide-spread axles which have been popular with flat-bed operators.

In the manufacturing engineering department, emphasis was placed on growth and adjustments. Flat-bed trailer sales in 1988 almost doubled, thereby necessitating improvements in the manufacturing areas. Improvement in product flow, point-of-use storage, just-in-time production and manufacturing cell processing conceptions received primary focus throughout 1988.

To the plasma torch work cell were added a second cutting table, two 100 amp torches, a vacuum handling system, water filter unit and an integrated press brake. These additions make it possible for a newly-designed two-piece web for flat-beds to be prepared completely at the work cell. The dual table set-up along with a hand-held plasma unit for scrap preparation resulted in cost reductions and enhanced quality production.

In order to utilize better the manufacturing capacity at the Buck Creek trailer plant, dump trailer production and drop-frame production were moved to the heavy weldment shop at the main plant complex in Lufkin.

The scenario of 1979-82, when LUFKIN met robust customer demand by converting under-utilized Trailer Division capacity to pumping unit manufacture, has been reversed now. About half of the heavy weldment shop has been dedicated to the manufacturing of trailers due to record-breaking trailer sales which strained trailer plant capacity to its limits. All of LUFKIN's "LightWeight" drop-frame flat-beds and advanced "Ultralight" dump trailers are being built now at the heavy weldment shop.

A significant re-tooling and re-training program led by team members from both departments made this possible in a minimum period of time. The Trailer Division can focus now on growth opportunities for its line of flat-beds and continue to improve the efficiency of its manufacture of dry freight vans.

Left: This new beam welding machine significantly reduces assembly time. In addition, the re-designed beam allows greater hauling capacities, giving LUFKIN an increased selling edge.

Right: Sales of LUFKIN trailers in 1988 topped out at $73.5 million, a new record. Last year's sales were $66.5 million.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Financial Review & Financial Statements

Index

Beside an azure lake beneath Montana's big sky, a LUFKIN pumps in solitude.

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 1988, foreign sales accounted for approximately 16 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 Lowell, Arkansas; Atlanta, Georgia; Shreveport, Louisiana; 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 financial 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 2,200 people, of whom approximately 1,500 are hourly paid. The Company has an open shop contract with three labor unions, all members of the AFL-CIO, which runs to September 30, 1990. 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, 1989, the Company had approximately 1,100 record holders of its common stock.

Lufkin has paid cash dividends for 49 consecutive years. Total dividend payments were $11,941,000 in 1988 and $13,664,000 in 1987.

Quarterly Financial Data

In millions, except per share data	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
1988				
Net sales	$45.4	$42.6	$45.7	$47.5
Gross income	4.9	3.8	2.9	2.8
Net earnings (losses)	7.1*	.7	(.7)	(1.2)
Earnings per share	4.16*	.40	(.40)	(.68)
Dividends per share	2.00	2.00	1.50	1.50
1987				
Net sales	$29.4	$37.4	$39.4	$51.9
Gross income	(1.1)	3.5	3.0	5.1**
Net earnings (losses)	(1.4)	.6	.2	1.7**
Earnings per share	(.83)	.38	.11	.96**
Dividends per share	2.00	2.00	2.00	2.00

*Includes the cumulative effect of $5.2 million for the change in accounting for income taxes adopted on January 1, 1988.

**A liquidation of LIFO inventories occurring during the fourth quarter of 1987 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, 1988 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

(Thousands of dollars)	**1988**	1987	1986
Net sales:			
Machinery Division			
Pumping units	**$ 73,342**	$ 62,565	$ 51,744
Gears	**26,386**	22,082	19,353
Trailer Division	**73,489**	66,524	52,878
Industrial Supplies Division	**7,941**	6,906	6,467
Total net sales	**181,158**	158,077	130,442
Operating income (loss):			
Machinery Division	**(3,740)**	(9,928)	(8,828)
Trailer Division	**(2,258)**	551	(254)
Industrial Supplies Division	**(909)**	(283)	(280)
Total operating income (loss)	**(6,907)**	(9,660)	(9,362)
Assets:			
Machinery Division	**113,107**	110,824	110,537
Trailer Division	**68,414**	59,119	48,896
Industrial Supplies Division	**5,485**	5,123	4,441
General corporate	**59,165**	89,417	108,737
Total assets	**246,171**	264,483	272,611
Capital expenditures:			
Machinery Division	**3,738**	3,706	6,177
Trailer Division	**3,318**	2,935	1,269
Industrial Supplies Division	**244**	148	19
General corporate	**274**	400	(98)
Total capital expenditures	**7,574**	7,189	7,367
Depreciation:			
Machinery Division	**9,025**	9,075	8,848
Trailer Division	**1,008**	744	616
Industrial Supplies Division	**196**	141	117
General corporate	**999**	944	951
Total depreciation	**11,228**	10,904	10,532
Net sales by geographic region:			
United States	**152,498**	137,124	107,101
Canada	**11,030**	9,799	9,062
Latin America	**10,692**	5,750	6,122
Other regions	**6,938**	5,404	8,157
Total net sales	**$181,158**	$158,077	$130,442

Management's Analysis of Operating Results and Financial Condition

Operating Results

Net sales, operating income and net earnings all improved in 1988. Sales for 1988 were $181.2 million compared to $158.1 million in 1987, an increase of 15 percent. Sales for 1987 had increased 21 percent from 1986 sales totaling $130.4 million. The Company reported a loss before income taxes of $.7 million in 1988 as compared to a loss of $.6 million in 1987. Net earnings increased to $5.9 million in 1988 as compared to $1.1 million in 1987 and $2.8 million in 1986. The large increase in 1988 was due primarily to the adoption effective January 1, 1988, of the Statement of Financial Accounting Standards No. 96, "Accounting for Income Taxes." The cumulative effect of this change amounted to $5.2 million in 1988.

Net sales in each of the Company's product lines increased in 1988. In the Machinery Division, pumping unit sales increased 17 percent and gears increased 19 percent. Trailer Division sales increased 10 percent and Industrial Supplies Division sales increased 15 percent. Each division likewise reported increased sales in 1987 over 1986.

The Company's pumping unit markets were adversely affected by the instability in the market price of oil and the resulting reduction in drilling activity during 1986 through 1988. The number of pumping units shipped during 1988 decreased by 15 percent over 1987. The number of units shipped had increased in 1987 by 26 percent.The reduction in units shipped in 1988 was offset by a 19 percent increase in average unit size in 1988 after an 18 percent increase in 1987. Also, the selling prices of pumping units were increased in 1988 after being significantly reduced the previous year.

While sales increased in 1988 for both of the Machinery Division's product lines, the Division reported an operating loss of $3.7 million for 1988 compared to operating losses of $9.9 million in 1987 and $8.8 million in 1986. The decreased loss in 1988 is primarily the result of increased gear sales as well as improved prices for gears and pumping units.

The Machinery Division's backlog at December 31, 1988 was approximately $19.0 million as compared to $21.5 million at December 31, 1987. However, due to the uncertainty of oil prices and the supply/demand imbalance of oil, the Company is unsure of prospects for 1989 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 Trailer Division's sales were a record $73.5 million in 1988. This was a 10 percent increase over 1987 sales of $66.5 million. Trailer sales in 1986 were $52.9 million. Although the sales of the Company's trailers has remained high, the low demand for trailers in the industry as a whole has resulted in reduced selling prices.

After allocation of corporate expenses, the Trailer Division reported an operating loss of $2.3 million in 1988, compared to an operating profit of $.6 million in 1987 and an operating loss of $.3 million in 1986. The net operating loss in 1988 was caused by the continuing competitive conditions in the trailer industry and the significant increased cost of aluminum during the year.

The Trailer Division had a backlog of approximately $15.5 million in sales orders at the beginning of 1989 as compared to $26.0 million at the beginning of 1988. The Company believes that trailer sales will be strong throughout 1989, although competitive conditions are expected to continue.

Interest income decreased 28 percent in 1988 because of the sharply reduced level of temporary investments and investments in marketable securities held during the year. This decrease was partially offset by a 10 percent increase in the installment notes and contracts receivable held during 1988 as compared to 1987.

Liquidity and Capital Resources

At December 31, 1988, the Company had working capital of $109.2 million as compared to $112.4 million at December 31, 1987, and $103.4 million at December 31, 1986.

The Company believes that existing working capital is sufficient to satisfy its 1989 requirements. In recent years, the expansion of the Company's facilities has been financed with internally generated funds and the Company plans financing any future expansion and improvements of its facilities in this manner.

Consolidated Balance Sheet

December 31, 1988 and 1987
(Thousands of dollars)

Assets	1988	1987
Current assets:		
Cash	$ 1,387	$ 214
Temporary investments	20,053	43,852
Accounts receivable, less allowance of $225,000	23,342	25,518
Refundable income taxes	2,508	3,521
Installment notes and contracts receivable, less allowance of $400,000 in 1988 and $75,000 in 1987	35,194	31,982
Inventories	37,529	23,398
Total current assets	120,013	128,485
Property, plant and equipment:		
Land	9,319	9,175
Buildings	51,148	49,640
Machinery and equipment	134,012	129,010
	194,479	187,825
Less accumulated depreciation	95,690	85,382
Net property, plant and equipment	98,789	102,443
Investments in marketable securities	24,294	31,467
Other assets	3,075	2,088
	$246,171	$264,483

Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 8,484	$ 9,325
Accrued liabilities:		
Payrolls	791	1,129
Taxes	1,503	2,197
Dividends declared	—	3,416
Total current liabilities	10,778	16,067
Deferred income taxes	16,716	22,284
Stockholders' equity:		
Common stock, par $1 per share; 4,000,000 shares authorized; 1,698,024 issued in 1988 and 1,708,024 issued in 1987	1,698	1,708
Capital in excess of par	15,364	15,454
Retained earnings	201,615	208,970
Total stockholders' equity	218,677	226,132
	$246,171	$264,483

See notes to consolidated financial statements.

Consolidated Statement of Earnings

Years ended December 31, 1988, 1987 and 1986
(Thousands of dollars, except per share data)

	1988	1987	1986
Revenues:			
Net sales	**$181,158**	$158,077	$130,442
Interest income, net	**6,666**	9,237	10,001
	187,824	167,314	140,443
Expenses:			
Cost of sales	**166,728**	147,548	122,566
Selling, general and administrative expenses	**21,813**	20,379	17,921
	188,541	167,927	140,487
Earnings (loss) before income taxes and the cumulative effect of the change in accounting for income taxes	**(717)**	(613)	(44)
Income taxes (benefits)	**(1,483)**	(1,679)	(2,851)
Earnings before the cumulative effect of the change in accounting for income taxes	**766**	1,066	2,807
Cumulative effect of the change in accounting for income taxes	**5,170**	—	—
Net earnings	**$ 5,936**	$ 1,066	$ 2,807
Earnings per share			
Earnings before the cumulative effect of the change in accounting for income taxes	**$ 0.45**	$ 0.62	$ 1.64
Cumulative effect of the change in accounting for income taxes	**3.03**	—	—
Net earnings per share	**$ 3.48**	$ 0.62	$ 1.64

Consolidated Statement of Stockholders' Equity

Years Ended December 31, 1988, 1987 and 1986
(Thousands of dollars, except per share data)

	Common Stock		Capital	Retained
	Shares	Amount	In Excess of Par	Earnings
Balance December 31, 1985, as restated	1,719,210	$1,719	$15,555	$237,999
Net earnings, as restated				2,807
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
Net earnings				1,066
Cash dividends, $8.00 per share				(13,664)
Balance December 31, 1987	1,708,024	1,708	15,454	208,970
Net earnings				5,936
Cash dividends, $7.00 per share				(11,941)
Stock purchased and retired	(10,000)	(10)	(90)	(1,350)
Balance December 31, 1988	1,698,024	$1,698	$15,364	$201,615

See notes to consolidated financial statements.

Consolidated Statement of Cash Flows

Years ended December 31, 1988, 1987 and 1986
(Thousands of dollars)

	1988	1987	1986
Cash flows from operating activities:			
Earnings before the cumulative effect of the change in accounting for income taxes	**$ 766**	$ 1,066	$ 2,807
Adjustments to reconcile earnings to net cash provided (used) by operating activities:			
Depreciation	**11,228**	10,904	10,532
Deferred income taxes	**(398)**	409	534
Changes in assets and liabilities:			
(Increase) decrease in accounts receivable	**2,176**	(9,254)	17,599
(Increase) decrease in refundable income taxes	**1,013**	1,387	(4,908)
(Increase) decrease in installment notes and contracts receivable	**(3,212)**	(2,760)	1,108
(Increase) decrease in inventories	**(14,131)**	(2,350)	1,063
Increase (decrease) in accounts payable	**(841)**	3,500	(2,255)
Increase (decrease) in accrued liabilities	**(4,448)**	561	(3,596)
Net cash provided (used) by operating activities	**(7,847)**	3,463	22,884
Cash flows from investing activities:			
Net additions to property, plant and equipment	**(7,574)**	(7,189)	(7,367)
(Increase) decrease in investments in marketable securities and other assets	**6,186**	17,498	(12,761)
Net cash provided (used) by investing activities	**(1,388)**	10,309	(20,128)
Cash flows from financing activities:			
Dividends paid	**(11,941)**	(13,664)	(17,113)
Stock purchased and retired	**(1,450)**	—	(2,237)
Net cash provided (used) by financing activities	**(13,391)**	(13,664)	(19,350)
Net increase (decrease) in cash and temporary investments	**$(22,626)**	$ 108	$(16,594)

See 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 $22,076,000 and $29,438,000 at December 31, 1988 and 1987, 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 amounts due after one year ($23,920,000 at December 31, 1988 and $21,370,000 at December 31, 1987) are included in current assets in accordance with trade practice.

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.

Expenditures for maintenance and repairs were $5,019,000 in 1988, $4,063,000 in 1987 and $3,383,000 in 1986.

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 and other temporary differences between financial and tax reporting methods.

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

Restatement of 1986 financial statements: 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 1986 interest income. The company did not consider this to be a significant change. During 1988, at the request of the Securities and Exchange Commission, the 1986 financial statements have been retroactively restated in order to present, as a prior period adjustment, the effects of this change in method of income recognition. Interest income in 1986 has been reduced by $2,000,000 and net earnings decreased by $1,080,000, net of taxes, or $0.63 per share. Accordingly, retained earnings as of December 31, 1985, has been increased by $1,080,000.

Other: During 1988, the Company adopted Financial Accounting Standards Board Statement No. 95, "Statement of Cash Flows," resulting in the restatement of previously reported statements of changes in consolidated financial position for 1987 and 1986.

Certain items have been reclassified in the 1987 and 1986 consolidated financial statements to conform with 1988 classifications.

(2) Business segment information

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

Sales to J.B. Hunt Transport, Inc., a customer of the Company's trailer products, accounted for 12% of net sales in 1988, 16% in 1987 and 12% in 1986.

(3) Income taxes

The income tax provision (credit) for 1988, 1987 and 1986 consisted of the following:

(Thousands of dollars)	**1988**	1987	1986
Amounts currently refundable	**$(1,085)**	$(2,088)	$(3,385)
Amounts deferred	**(398)**	409	534
	$(1,483)	$(1,679)	$(2,851)

A reconciliation of the provision for income taxes to the statutory United States tax rate is as follows:

(Thousands of dollars)	**1988**	1987	1986
Taxes computed at statutory rate	**$ (244)**	$ (245)	$ (20)
Investment tax credits	**—**	—	(693)
Tax-exempt interest	**(694)**	(1,209)	(1,665)
Dividend income exclusion	**(177)**	(287)	(266)
Rate differential on NOL carryback to 1985	**(332)**	—	—
Other, net	**(36)**	62	(207)
Actual provision	**$(1,483)**	$(1,679)	$(2,851)

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

(Thousands of dollars)	1988	1987	1986
Excess of tax depreciation over book depreciation	**$ 421**	$ 659	$ 2,054
DISC earnings not currently subject to tax	**(171)**	(201)	(231)
Income on installment notes	**(312)**	53	(1,289)
Other	**(336)**	(102)	—
	$ (398)	$ 409	$ 534

Effective January 1, 1988, the Company adopted the Statement of Financial Accounting Standards No. 96, "Accounting for Income Taxes." The cumulative effect of the change in accounting for income taxes at that date amounted to $5,170,000.

(4) Inventories

Inventories used in determining cost of sales were as follows:

(Thousands of dollars)	1988	1987	1986	1985
Finished goods	**$11,087**	$ 7,091	$ 6,205	$ 5,865
Work in process	**11,528**	7,720	7,864	9,085
Raw material	**14,914**	8,587	6,979	7,161
	$37,529	$23,398	$21,048	$22,111

Had the first-in, first-out method been used in determining inventory values, inventories would have been $27,809,000, $23,353,000, $27,347,000 and $28,424,000 higher at December 31, 1988, 1987, 1986 and 1985, respectively.

During 1987 and 1986 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 $520,000 or $.30 per share in 1987 and $2,162,000 or $1.26 per share in 1986.

(5) Retirement plans

The Company has noncontributory pension plans covering substantially all employees. The benefits provided by these plans are measured by length of service, compensation and other factors, and are currently being funded through trusts established under the plans. Funding of retirement costs for these plans complies with the minimum funding requirements specified by the Employee Retirement Income Security Act.

In 1987, the Company adopted Statement of Financial Accounting Standards No. 87, "Employers' Accounting for Pensions". Pension expense and related disclosures for plans in 1986 were determined under the provisions of previous accounting principles.

The following tables detail the components of pension income and expense, the funded status of the plans and amounts recognized in the Company's consolidated balance sheet, and major assumptions used to determine these amounts.

(Thousands of dollars)	1988	1987
Components of pension (income) expense		
Service cost	**$ 2,141**	$ 1,704
Interest cost	**4,638**	4,350
Actual return on plan assets	**(6,850)**	(6,559)
Net amortization and deferral	**(923)**	(1,070)
	$ (994)	$ (1,575)
Plan assets at fair value	**$80,694**	$78,750
Actuarial present value of projected benefit obligations		
Accumulated benefit obligations		
Vested	**(42,506)**	(43,282)
Nonvested	**(5,659)**	(4,927)
Provision for future salary increases	**(14,359)**	(9,981)
Plan assets over projected benefit obligations	**18,170**	20,560
Unrecognized transition gain	**(18,242)**	(19,168)
Unrecognized loss	**2,578**	104
Unrecognized prior service cost	**63**	79
Net prepaid pension cost	**$ 2,569**	$ 1,575
Major assumptions at year-end		
Discount rate	**8%**	8%
Rate of increase in compensation levels	**6%**	6%
Expected long-term rate of return on plan assets	**9%**	9%

The pension expense was $19,000 in 1986.

The Company also has defined contribution plans covering substantially all of its salaried employees. Pension expense for these plans totaled $577,000, $437,000 and $272,000 in 1988, 1987 and 1986, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(6) Common Stock

In May 1987, the Board of Directors adopted a "Shareholder Rights Plan" designed to protect against unsolicited attempts to acquire control of the Company that the Board believes are not in the best interest of the stockholders. The Plan provides for a dividend of one common stock purchase right for each outstanding share of common stock. Under certain conditions, each right may be exercised to purchase one share of common stock at an exercise price of $400, subject to adjustment. Under certain circumstances, the rights entitle holders to purchase the common stock of the Company or an acquiring company having a value of twice the exercise price of the rights. The rights would become exercisable, or transferable apart from the common stock, ten days after a person or group acquired 20% or more, or announced or made a tender offer for 30% or more, of the outstanding common stock. Under certain circumstances, all rights owned by an acquiring person would be null and void. The rights expire on May 31, 1996 and may be redeemed by the Company at any time prior to the occurrence of certain events at $.05 per right.

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Stockholders of Lufkin Industries, Inc.:

We have audited the accompanying consolidated balance sheet of Lufkin Industries, Inc. (a Texas corporation), and subsidiaries as of December 31, 1988 and 1987, and the related consolidated statements of earnings, stockholders' equity and cash flows for each of the three fiscal years in the period ended December 31, 1988. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amount and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Lufkin Industries, Inc., and subsidiaries as of December 31, 1988 and 1987, and the results of their operations and their cash flows for each of three fiscal years in the period ended December 31, 1988, in conformity with generally accepted accounting principles.

As discussed in Notes 3 and 5 to the consolidated financial statements, the Company adopted Statements of Financial Accounting Standards No. 96 "Accounting for Income Taxes" in 1988 and No. 87 "Employers' Accounting for Pensions" in 1987.

ARTHUR ANDERSEN & CO.

Houston, Texas
February 17, 1989

Directors and Officers

Board of Directors

S.W. Henderson, Jr., Manager of his own investments
*S.W. Henderson, III, Chairman of the Board and Chief Executive Officer 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., Retired Vice President
*J.L. Wiener, Jr., Partner, Wiener, Weiss, Madison & Howell (law firm)
T.E. Wiener, Principal, Franklin, Margulies & Huntington (law firm)

*Member Executive Committee

Officers

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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
E.L. Watts, Vice President
C.J. Haley, Jr., Secretary-Treasurer
R.E. Myers, Jr., Assistant Secretary
J.B. Massingill, Assistant Treasurer


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