ANNUAL REPORT 1989

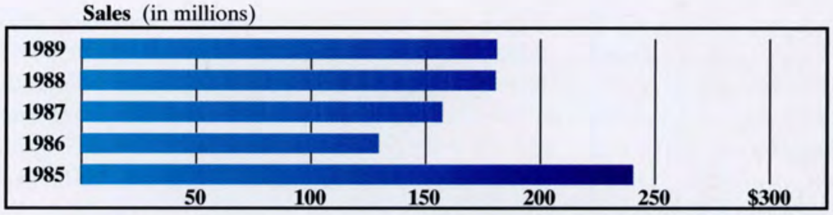
LUFKIN


CRETE

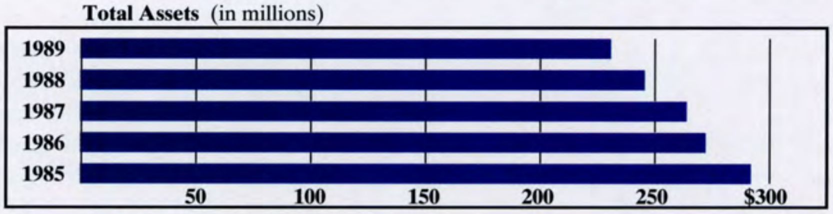
Financial Highlights

(In thousands of dollars, except per share data)	**1989**	1988	1987	1986	1985
Net sales	**$182,000**	$181,158	$158,077	$130,442	$241,894
Net earnings (loss)					
Earnings (loss) before the cumulative effect of the change in accounting for income taxes	**(6,418)**	766	1,066	2,807	28,615
Cumulative effect of the change in accounting for income taxes	**—**	5,170	—	—	—
Net earnings (loss)	**(6,418)**	5,936	1,066	2,807	28,615
Earnings (loss) per share					
Earnings (loss) before the cumulative effect of the change in accounting for income taxes	**(3.78)**	0.45	0.62	1.64	16.64
Cumulative effect of the change in accounting for income taxes	**—**	3.03	—	—	—
Net earnings (loss) per share	**(3.78)**	3.48	0.62	1.64	16.64
Cash flows from operating activities	**11,109**	(7,847)	3,463	22,884	46,718
Total assets	**227,248**	246,171	264,483	272,611	292,471
Cash dividends per share	**6.00**	7.00	8.00	10.00	11.00
Book value per share	**119.00**	128.78	132.39	139.77	148.85

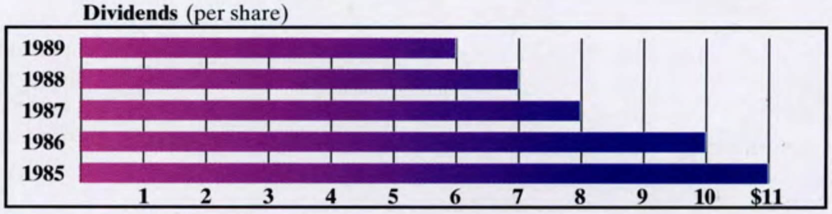
Sales (in millions)



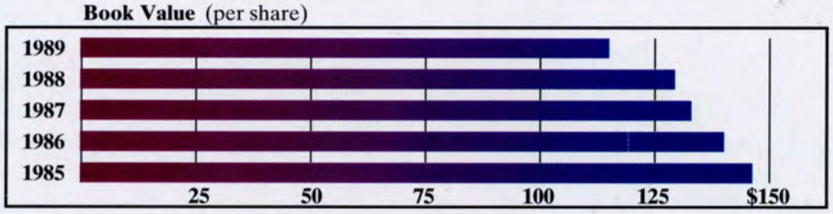
Total Assets (in millions)



Dividends (per share)



Book Value (per share)



Left: LUFKIN trailers are seen along highways throughout the United States. This one, on its maiden voyage, rolls along a bridge across Sam Rayburn Reservoir east of Lufkin

1989 Annual Report - Letter To Stockholders

The year 1989 was one of transition and change. We continued our strategy of shifting from a one-product Company to a broadly diversified Company with primary strengths in engineering, manufacturing, and sales. There were many cross currents in our Company in 1989 as some markets continued to decline, yet we made significant progress and growth in many of the markets that we serve. Although we had a loss from operations in 1989, we had a significant improvement in cash flow from operating activities. The primary cause for the loss was the decline in the oil field business which was due to the decrease in oil field activity. The drilling rig count, which is the primary driver for the oil field business, was at a 40-year low in 1989. As a result, our oil field products were at the lowest level in more than 40 years.

The good news is that we increased the growth in other areas, and have continued to build a strong foundation for the future growth of other businesses. Following is a brief summary of our various business units:

Oil Field Equipment - We continued to improve our product and make further penetration into all of the markets that we serve. We have introduced many innovative services such as a portable pumping unit for rental/lease/purchase, used units, rebuilt units, and sales and service on a worldwide basis.

Trailer Division - The Trailer Division recorded an 11 percent increase in sales to an all-time record of $81.5 million and continued to improve and broaden its entire product line. Many low cost improvements were made in the manufacturing facilities to increase efficiencies, shorten lead time and improve material handling. Although we are seeing a downturn in the transportation industry, we will make adjustments in our operating plan in order to continue to improve the profitability of the Trailer Division.

Industrial Gears - We experienced another very good growth year in industrial gears as volume expanded approximately 27 percent to $33.5 million. Incoming orders remain strong, and we expect to have about the same growth rate in 1990. We are moving to expand our industrial gear business in all areas, particularly in high speed units, repairs and parts. We will continue aggressively to pursue this market.

Special Products - We experienced dramatic growth in this market of approximately 90 percent to $8.5 million. Special products comprise casting, fabrication, machining and assembly operations. This segment of our business is an extremely important growth area, and we are moving forcefully to capture new markets and broaden our presence in all of these areas.

Industrial Supplies Division - Sales totaled approximately $8.0 million, and the business continues its steady growth in the regional markets that it serves. We continue to improve the product lines and service as we serve the industrial base of East Texas. In addition to the regional market, the Industrial Supplies Division performs an important service to the manufacturing groups within the Company by providing supplies and services to all of our operations.

More Efficient and Competitive - We have continued to position and shape our organization to respond better to the various markets that we serve. As the oil field business has continued to decline, we have moved to accelerate the growth of our gears, trailers, and special products businesses. This has required many organizational changes and shifts in responsibility and focus. Many LUFKIN team members are availing themselves of the educational activities offered by the Company and are improving their skills to help build a better, stronger Company for the future.

Outlook for the Future - We will continue to face tough competitive conditions in all of the markets that we serve in the 1990's. We are hopeful that the oil industry will begin a gradual recovery, and we are well-positioned to take advantage of any improvement in that market. Industrial gears are a strong growth market, and we intend to increase our position to be a worldwide force in this market. Although we face a temporary downturn in the trailer industry, we are continuing to improve our efficiency and our capability, and we are determined to be profitable at any level of operation.

We will continue to improve our core business and to build on our traditional strengths while we use our resources to develop and improve many new markets.

We are a strong engineering, manufacturing, and sales organization with a sound technology base and exceptional financial strength. We will build on this base in the future to continue to improve our total operation. We are blessed with a dedicated group of hardworking, energetic, and creative people. It is their commitment to the LUFKIN values which has enabled us to make the transition during this difficult time, and it is the driving force that will enable us to continue to build a better and stronger company. Our primary corporate objective is to continue to improve the long-term growth and profitability of your company.

F B Stevenson

Frank B. Stevenson
President and
Chief Executive Officer

Right: A LUFKIN MARK II pumping unit lifts its oil as cattle gather beneath a windmill near Odessa, Texas

Machinery Division

In the Machinery Division of Lufkin Industries, Inc., the Company manufactures products in three broad markets: oil field products, industrial and marine gearing products, and special products for diversified industries. These product groups share manufacturing facilities consisting of machining, foundry and steel fabrication.

OIL FIELD PRODUCTS

In the oil field products segment of the Machinery Division, a complete line of oil field sucker rod pumping units, in all API sizes and stroke lengths, are manufactured and marketed. As an innovator in sucker rod pumping unit design and manufacturing, this segment of the business offers a wide array of products including crank-balanced, Mark II, RM series, beam-balanced, slant hole, low profile and portable trailer-mounted sucker rod pumping units.

In addition to these units, another line of pumping units called the LM series is manufactured and marketed by the oil field product segment. The LM series is a line of pumping units built around a large quantity of high quality but non-LUFKIN gear reducers purchased at a very economical cost in 1988. This has made it possible to compete in the currently price-conscious market. Due to the favorable pricing structure of the LM series, the Company has been able to compete with the large volume of used equipment which is available throughout the oil patch.

In 1988, the Company introduced the RM series pumping unit which employs a new geometry similar to the crank-balanced unit with many of the characteristics of the Mark II line of pumping units. The market has been receptive to the RM Series.

Of the different types of units produced by the Company, the conventional crank-balanced unit is the most widely accepted and accounts for about 33% of the pumping unit revenue. The Mark II and RM series units contribute approximately 36%. The LM series, beam-balanced, slant hole, trailer-mounted units together with service and repair parts account for the remaining 31%.

In addition to the many standard models and configurations available from the Company's catalog, special designs are available to meet any unusual requirements presented by customers.

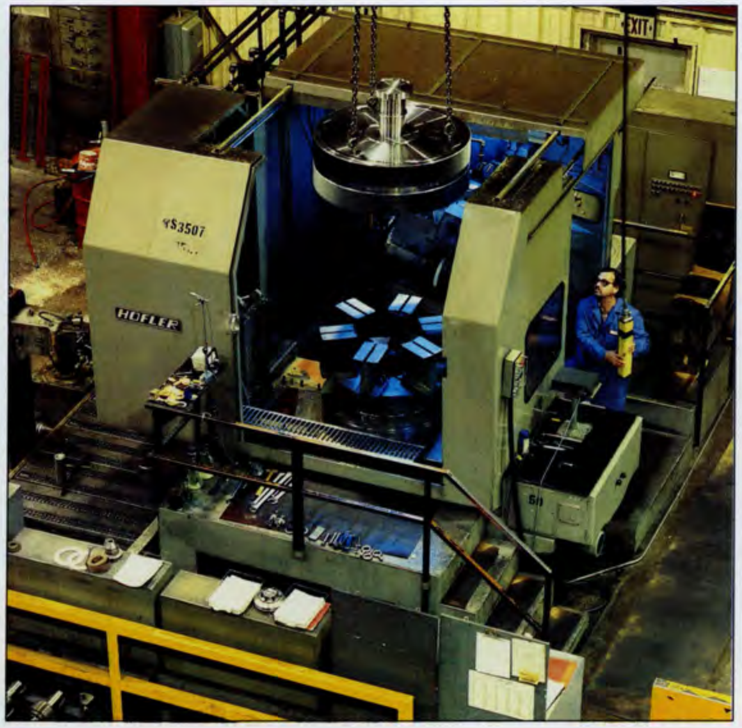
Key growth areas for new pumping unit applications in 1989 were in the methane coal degasification projects in northwestern New Mexico and in the Black Warrior Basin area of Alabama. To increase LUFKIN's visibility in these areas and to meet the needs of customers, new sales offices were opened in Farmington, New Mexico, and in Tuscaloosa, Alabama during the last quarter of 1989. Sales increased in these areas and the Company expects them to continue to increase in 1990.

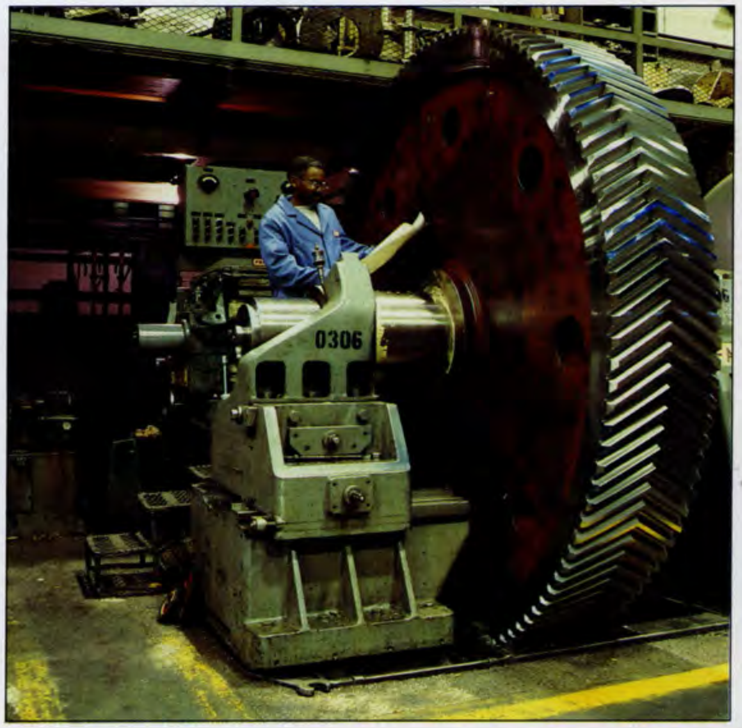
The parts, field service and repair business for oil field products is managed out of several field service centers located strategically throughout the oil patch. Sales of replacement parts and used pumping units, which were refurbished at these field service centers, were strong in 1989. LUFKIN expects continued growth in this sales area during 1990.

Below Left: A LUFKIN high speed precision gear is being positioned on a grinder for final tooth finishing

Below Right: This large sugar mill drive was in LUFKIN'S shop for repair. It utilized this machine's capacity with about an inch to spare to clear the floor

Right: Pouring of molten iron to make housings for Lufkin products is always a spectacular sight





Machinery Division

Although a significant overall reduction occurred in domestic pumping unit sales, international sales of pumping units increased slightly in 1989 over 1988 levels. LUFKIN's international sales group operates primarily in South America, Europe, the Middle East, the Far East and Australia. For the first time ever, LUFKIN made pumping unit sales for installations in the United Kingdom and in Sicily in 1989.

Although overall pumping unit sales are expected to improve in 1990, sales will continue to be depressed in comparison to traditional levels until the factors which have devitalized the oil industry as a whole have diminished.

INDUSTRIAL AND MARINE GEARING

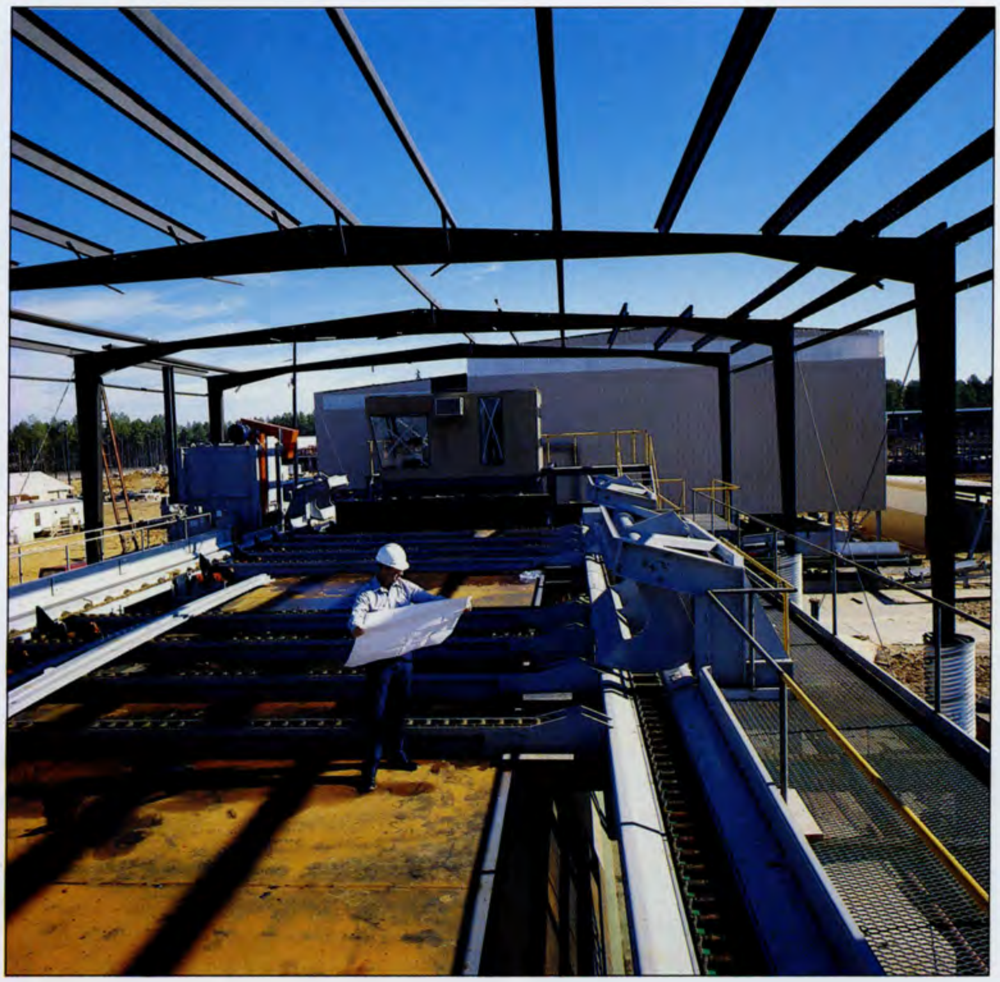
The industrial and marine gearing segment of the Machinery Division manufactures a complete line of heavy duty industrial, marine and special purpose gear units along with custom gearing as a component of products built by customers. The gear product line includes units weighing from about 300 pounds to as much as 250 tons. The Company's gear units are marketed throughout the world.

LUFKIN's gear units are applied in the petrochemical, rubber, sugar, paper, marine propulsion, plastics, utilities, food processing and coal processing industries and other industries requiring heavy duty gear drives.

The Company is considered one of the world leaders in high performance gear drives for transmitting high horsepowers at high speeds. Several units have been built which are capable of transmitting 80,000 horsepower and units are currently in production with 60,000 horsepower drives. These units will be tested fully loaded on LUFKIN'S test stand in the spring of 1990.

The Company believes that gear applications for electrical power generation will be in demand for the next several years. Currently, the Company is making quotations on units with 100,000 horsepower ratings. The Company also believes that plastics will continue to be a high growth material for the coming years and many types of gears should be needed to service this industry. LUFKIN intends to be a viable competitor for this business.

In addition to high performance, high horsepower gear drives, LUFKIN competes for business in the standard lines of gear units and open gearing where higher volume sales and production rates are possible. In 1989, efforts were made to develop further these markets. Some gear units were redesigned to utilize sophisticated materials to build a more compact and economical gear unit.



Left: Many of the component parts of this sawmill being constructed in Louisiana were built in LUFKIN's fabrication department

Below: One of the many diversified products LUFKIN produced for commercial customers during 1989 was counterweights for industrial forklifts

Machinery Division

Also, the Company expanded the range of gear products it provides to include loose gearing and proprietary designs which are sold to customers to be used as components in their products.

Another segment of the Company's gear business involves the repair and replacement of parts. Special emphasis was placed on this business in 1989. Custom repair orders amounted to approximately 32% of gear sales in 1990.

During 1989, marine gear sales began to improve slightly, and are expected to show an improvement in 1990, especially for inland river applications.

SPECIAL PRODUCTS

The foundry and fabrication operations of the Machinery Division produced a number of products for widely diversified markets and thereby successfully utilized a portion of the Division's excess capacity. In addition to meeting requirements for pumping unit and industrial gear castings, the foundry continued its pursuit of the commercial casting business. Approximately 9,000 tons of gray and ductile iron castings were shipped in 1989 to customers serving the industrial lift truck, pump, compressor, transportation, electric motor, valve, mining and construction markets.

Indicative of the fabrication department's diversification efforts were its commercial work including manufacturing sawmill equipment, plastics extrusion machinery and structural components for telecommunication satellite earth stations.

MANUFACTURING

The downturn during the past several years in the oil field market has resulted in extreme pressure on price structure throughout the industry. To make it possible for LUFKIN to obtain a higher share of what market there is for oil field products, the Company has continued to invest in improved and innovative manufacturing techniques.

A major focus in 1989 was the expansion and improvement of the company's overall industrial gear manufacturing, new commercial and special products manufacturing and industrial gear repair and service operations.

Pumping unit manufacturing technology continues to be improved on an ongoing basis. These units are manufactured in a modified automated environment.

To improve quality and substantially reduce lead times for customers, some industrial gear units were produced in the pumping unit "manufacturing cells." This linked, flow-through manufacturing

Right: From originally supplying the center part where the reflector attaches to the base, LUFKIN now supplies parts of the reflector framework on orders for various sizes of antennas from 14 feet to 84 feet

Below: Several of the component parts of this 20.1 meter (65+ feet) satellite antenna earth station were manufactured by the fabrication department for a leading satellite communication customer for eventual shipment overseas.

Machinery Division

arrangement not only benefits production but permits growth of industrial gear business with existing available capacity.

The Company made capital investments throughout the manufacturing areas of the Machinery Division during 1989, particularly in machining operations. Several machines were rebuilt to new machine specifications and fitted with modern numerical controls. One major installation was a gear grinder used for precision grinding of industrial gears. This grinder is one of three such grinders currently in the Company's production facilities.

Additional gear production machines were purchased in 1989 for delivery in 1990. The Company purchased a large 10-foot diameter precision gear hobbing machine for production of very precise gears. Two additional precision gear hobbing machines were ordered in 1989 for delivery in 1990 and 1991.

LUFKIN's capacity to test its high speed gear units has been expanded to allow testing of a larger number of units as well as testing units of considerably higher horsepowers.

Additional equipment purchased in 1989 for the high speed gear test stand includes a 2,000 horsepower dynamometer and a 1,000 horsepower DC motor coupled with a new LUFKIN slave gear drive. Also, field service capabilities have been enhanced by the acquisition of modern portable testing equipment such as a new vibration analyzer, enabling service personnel to more quickly and accurately pinpoint problems with customer units in the field.

The Company's three primary casting facilities produce a wide range of castings in gray and ductile iron ranging in size from one-quarter pound to 40,000 pounds. The product mix in these facilities has shifted from castings predominately for LUFKIN products to a wide array of commercial castings in addition to LUFKIN components. The engineering staff for the foundries is experienced in product development and it uses computer-aided design and drafting to bring ideas to life for both LUFKIN and customer products.

The Company made significant investments in 1989 in CAD/CAM systems for the engineering and manufacturing areas. Some 26 of these work stations are operational and are performing design, drafting and manufacturing engineering functions. When fully implemented, these systems are expected to enhance productivity and to reduce the lead time required to execute critical engineering and production support functions.

Right: This horizontal machining center has been remanufactured and retrofitted with state of the art computer numerical controls and is used to produce small size industrial gear housings and other parts

Below: Significant investments were made in CAD/CAM (computer aided design and computer aided manufacturing) systems in the engineering and manufacturing areas

INDUSTRIAL SUPPLIES DIVISION

Total outside sales of the Industrial Supplies Division for 1989 were $7.9 million; sales to other divisions of Lufkin Industries were $4.4 million. Sales for the Jasper, Texas branch were slightly more than one million dollars.

The Industrial Supplies Division of Lufkin Industries is the oldest division of the Company and operates out of two locations, the main office and warehouse at the intersection of Loop 287 and Highway 94 in Lufkin, and from a small branch warehouse on Highway 190 East in Jasper.

This Division serves an area within an approximate 150-mile radius of Lufkin. The Division has five distinct categories of products and services. These are power transmission parts and services; welding equipment and supplies; plumbing fixtures and supplies; pole line hardware; and general industrial supplies.

The power transmission business experienced excellent growth in 1989, with sales increasing 115 percent from approximately $674,000.00 in 1988 to approximately $1.5 million in 1989.

Two significant events occurred in 1989 in this Division. First, a new product catalog was produced, displaying products from approximately 800 companies represented by the Industrial Supplies Division.

The second event was a complete face-lifting of the office and warehouse, resulting in much more visibility for the Division. An exterior metal was installed on outside walls and the office area roof was replaced. In addition, an attractive awning was erected which highlights the Bath & Kitchen Showplace area.

The forecast for 1990 is optimistic, predicting moderate and healthy growth as has been experienced during the past two years.

White exterior metal with black trim was installed on the outside walls of the Industrial Supplies Division and a new roof was placed on the office area.

Trailer Division

For the third consecutive year, the Trailer Division posted new record sales, with 1989 sales totaling $81,494 million, an increase of 10.9 per cent over 1988 sales of $73.5 million, which was a 10 per cent increase over 1987 sales of $66.5 million.

New trailer sales actually decreased in 1989, with 4,933 trailers sold as compared to 5,292 sold in 1988, a decrease of 359 units. The increase in dollar volume is largely attributed to product mix and to changes in specifications. For example, several major carriers moved from 48-foot trailers to 53-foot trailers.

Used trailer sales in 1989 increased by 213 per cent, amounting to $7.6 million compared to $2.4 million in 1988. The increase largely reflected the acceptance and subsequent sale, in part, of the largest block ever of used trailers by LUFKIN.

Engineering innovation and plant modernization were primary keys to continued success in 1989 of the Trailer Division. There were many technical achievements, but the development of the "thin wall" van was the highlight of them all. The main significance of this trailer is that its inside width is 100 inches compared to previous models with inside widths of 98.5 inches. This model was first introduced at the Southwest Truck Show in San Antonio, Texas. J.B. Hunt, after viewing the trailer at the show, placed an order for 1,400 "thin wall" vans.

New product development was the engineering department's primary focus in 1989. With customers demanding more and more cubic capacity, LUFKIN's design work is continuing on a trailer with even greater inside width than the "thin wall."

All phases of testing are complete for certification by the American Association of Railroads of van trailers for use in railroad "piggy back" operations, and trailers for this intermodal service will be offered for sale early in 1990.

Other new product developments in 1989 include an air-ride suspension option for the "ultra light" dump trailer, a new drop frame platform design for the chicken and turkey hauling industry, and a new light-weight extendable trailer with the capability of stretching from 45 feet to 75 feet in length.

Many changes were incorporated in the manufacturing areas of the Trailer Division during 1989. The dump and drop frame trailer production was re-located back to the main trailer plant from the Heavy Weldment shop at the downtown Lufkin main plant. While this re-installation was in process, improvements were made to the production lines. The dump set-up fixture was modified to allow a changeover from a high side "ultra light" dump to a low side in about two minutes, whereas the previous changeover usually required about 18 man-hours.

Other new equipment installed to improve production included a new plasma arc for the flat bed production area and one for the dump production line as well.

Planning for 1990 includes development and installation of several new systems designed to improve product quality and speed up production time.

Included in these plans is a steel decoiling system which will enable production to work from coil steel and should result in a dramatic inventory reduction and cost savings in the price of raw steel.

Also planned is an alternative side-building operation with rail, post and sheet punching systems to relieve pressure on the pierce rivet side machine. Production with this system will begin in the first quarter of 1990.

The Trailer Division is working toward product improvement, reliability and reduction of unnecessary costs in all areas. Currently more than 250 trailers equipped with special products are being monitored. Products such as fiberglass springs, light-weight sliding suspension components, anti-lock brake systems and other items are being studied because trailer engineers believe these are products of the future. With knowledge of these new products and developments, the Company believes that LUFKIN trailers will continue as a leader in the trucking industry.

Right: This is one of 1400 "thin wall" vans produced for J.B. Hunt in 1989

Left: This LUFKIN wide-spread, light-weight flatbed is loaded with mahogany hardwood from the Philippines which is used for flooring flatbeds built by the Trailer Division


12480
J.B. HUNT
J.B. HUNT


LUFKIN

FINANCIAL REVIEW & FINANCIAL STATEMENTS

Index

An air-balanced unit works along with other pumpjacks in a California vineyard

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 1989, foreign sales accounted for approximately 11 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 53 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 2,100 people, of whom approximately 1,400 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, 1990, the Company had approximately 1,100 record holders of its common stock.

Lufkin has paid cash dividends for 50 consecutive years. Total dividend payments were $10,188,000 in 1989 and $11,941,000 in 1988.

Quarterly Financial Data

In millions, except per share data	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
1989				
Net sales	$41.6	$48.5	$42.4	$49.5
Gross income (loss)	1.8	4.0	.7	(.9)
Net earnings (loss)	(2.3)	.7	(2.1)	(2.7)
Earnings (loss) per share	(1.33)	.39	(1.25)	(1.59)
Dividends per share	1.50	1.50	1.50	1.50
1988				
Net sales	$45.4	$42.6	$45.7	$47.5
Gross income	4.9	3.8	2.9	2.8
Net earnings (loss)	7.1*	.7	(.7)	(1.2)
Earnings (loss) per share	4.16*	.40	(.40)	(.68)
Dividends per share	2.00	2.00	1.50	1.50

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

Additional Financial Information

Shareholders may obtain additional financial information for the year ended December 31, 1989 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)	1989	1988	1987
Net sales:			
Machinery Division			
Pumping units	**$ 50,324**	$ 68,817	$ 59,665
Gears	**33,629**	26,386	22,082
Special products	**8,586**	4,525	2,900
Trailer Division	**81,494**	73,489	66,524
Industrial Supplies Division	**7,967**	7,941	6,906
Total net sales	**182,000**	181,158	158,077
Operating income (loss):			
Machinery Division	**(14,185)**	(3,740)	(9,928)
Trailer Division	**(1,474)**	(2,258)	551
Industrial Supplies Division	**(688)**	(909)	(283)
Total operating income (loss)	**(16,347)**	(6,907)	(9,660)
Assets:			
Machinery Division	**99,062**	113,107	110,824
Trailer Division	**34,531**	33,520	27,137
Industrial Supplies Division	**5,160**	5,485	5,123
General corporate	**88,495**	94,059	121,399
Total assets	**227,248**	246,171	264,483
Capital expenditures:			
Machinery Division	**3,012**	3,738	3,706
Trailer Division	**1,715**	3,318	2,935
Industrial Supplies Division	**267**	244	148
General corporate	**172**	274	400
Total capital expenditures	**5,166**	7,574	7,189
Depreciation:			
Machinery Division	**8,938**	9,025	9,075
Trailer Division	**1,069**	1,008	744
Industrial Supplies Division	**214**	196	141
General corporate	**994**	999	944
Total depreciation	**11,215**	11,228	10,904
Net sales by geographic region:			
United States	**162,824**	152,498	137,124
Canada	**6,281**	11,030	9,799
Latin America	**6,797**	10,692	5,750
Other regions	**6,098**	6,938	5,404
Total net sales	**$182,000**	$181,158	$158,077

Management's Analysis of Operating Results and Financial Condition

Results of Operations

Net sales for 1989 were $182.0 million as compared to $181.2 million in 1988. Sales for 1988 had increased 15% from 1987 sales totaling $158.1 million. The Company reported a loss before income taxes of $10.3 million in 1989 as compared to $.7 million in 1988 and $.6 in 1987. A net loss of $6.4 million was sustained in 1989 as compared to net earnings of $5.9 million in 1988 and $1.1 million in 1987. The larger earnings in 1988 were due primarily to the adoption in 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 other than pumping units increased in 1989. In the Machinery Division, pumping unit sales decreased 27% while gears increased 27% and special products increased 90%. Trailer Division sales increased 11% and Industrial Supplies Division had a small increase in sales. Each division had reported increased sales in 1988 over 1987.

The Company's pumping unit sales continued to be adversely affected by the market price of oil and the resulting reduction in drilling activity during 1987 through 1989. The number of pumping units shipped during 1989 decreased 19% after decreasing 15% in 1988. In addition, the average unit size decreased 15% in 1989 after increasing 19% in 1988. The reduced volume of pumping unit sales is directly related to the 15% lower average level of domestic drilling activity in 1989 compared to 1988. This was the lowest level of domestic drilling activity in over forty years. This significant decline in volume of units sold was only partially offset by minor price increases in 1989 and 1988. The Machinery Division's gear sales increased in 1989 and 1988 as a result of higher volume as well as price increases during both years.

The Machinery Division reported an operating loss of $14.2 million in 1989 compared to operating losses of $3.7 million in 1988 and $9.9 million in 1987. The increased loss in 1989 is primarily the result of the large decline in pumping unit sales. There are significant fixed costs associated with this Division's manufacturing facilities. These facilities are capable of producing more than six times as many units as were produced in 1989.

The Machinery Division's backlog at December 31, 1989 was approximately $30.2 million as compared to $19.0 million at December 31, 1988. Improvement in the Company's sales of pumping units is dependent on improved drilling activity which is directly affected by the demand for and price of oil. Due to the uncertainty of oil prices and the supply/demand imbalance of oil, the Company is unsure of it's Machinery Division prospects for 1990 and beyond.

The Trailer Division's sales were a record $81.5 million in 1989. This was an 11% increase over 1988 sales of $73.5 million. Trailer sales in 1987 were $66.5 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 $1.5 million in 1989, compared to an operating loss of $2.3 million in 1988 and an operating profit of $.6 million in 1987. The net operating loss in 1989 was caused by the continuing competitive conditions in the trailer industry and was only partially offset by decreased cost of aluminum during the year.

The Trailer Division had a backlog of approximately $12.8 million in sales orders at the beginning of 1990 as compared to $15.5 million at the beginning of 1989. The Company believes that the depressed condition of the trucking industry will cause its trailer sales to be lower in 1990.

Interest income decreased 4% in 1989 because of the reduced level of temporary investments and investments in marketable securities held during the year. This decrease was partially offset by a 6% increase in installment notes and contracts receivable held during 1989 as compared to 1988.

With the lessening of the annual inflation rate in the last several years, the Company believes that the impact of inflation on revenues, costs and expenses has been modest.

Liquidity and Capital Resources

At December 31, 1989, the Company had working capital of $105.2 million as compared to $109.2 million at December 31, 1988, and $112.4 million at December 31, 1987.

The Company believes that existing working capital is sufficient to satisfy its 1990 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. No significant commitments exist for future capital expenditures.

CONSOLIDATED BALANCE SHEET

December 31, 1989 and 1988
(Thousands of dollars)

Assets	**1989**	1988
Current assets:		
Cash	**$ 310**	$ 1,387
Temporary investments	**27,257**	20,053
Accounts receivable, less allowance of $225,000	**23,313**	23,342
Refundable income taxes	**—**	2,508
Installment notes and contracts receivable, less allowance of $650,000 in 1989 and $400,000 in 1988	**37,205**	35,194
Inventories	**29,426**	37,529
Total current assets	**117,511**	120,013
Property, plant and equipment:		
Land and improvements	**9,345**	9,319
Buildings	**51,446**	51,148
Machinery and equipment	**137,500**	134,012
	198,291	194,479
Less accumulated depreciation	**105,551**	95,690
Net property, plant and equipment	**92,740**	98,789
Investments in marketable securities	**12,661**	24,294
Other assets	**4,336**	3,075
	$227,248	$246,171

Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	**$ 8,062**	$ 8,484
Accrued liabilities		
Payrolls	**1,214**	791
Taxes and other	**3,026**	1,503
Total current liabilities	**12,302**	10,778
Deferred income taxes	**12,875**	16,716
Stockholders' equity:		
Common stock, par $1 per share; 4,000,000 shares authorized; 1,698,024 issued	**1,698**	1,698
Capital in excess of par	**15,364**	15,364
Retained earnings	**185,009**	201,615
Total stockholders' equity	**202,071**	218,677
	$227,248	$246,171

See notes to consolidated financial statements.

Consolidated Statement of Earnings

Years ended December 31, 1989, 1988 and 1987
(Thousands of dollars, except per share data)

	1989	1988	1987
Revenues:			
Net sales	**$182,000**	$181,158	$158,077
Interest income, net	**6,418**	6,666	9,237
	188,418	187,824	167,314
Expenses:			
Cost of sales	**176,416**	166,728	147,548
Selling, general and administrative expenses	**22,261**	21,813	20,379
	198,677	188,541	167,927
Earnings (loss) before income taxes and the cumulative effect of the change in accounting for income taxes	**(10,259)**	(717)	(613)
Income tax benefit	**(3,841)**	(1,483)	(1,679)
Earnings (loss) before the cumulative effect of the change in accounting for income taxes	**(6,418)**	766	1,066
Cumulative effect of the change in accounting for income taxes	**—**	5,170	—
Net earnings (loss)	**$ (6,418)**	$ 5,936	$ 1,066
Earnings (loss) per share			
Earnings (loss) before the cumulative effect of the change in accounting for income taxes	**$ (3.78)**	$ 0.45	$ 0.62
Cumulative effect of the change in accounting for income taxes	**—**	3.03	—
Net earnings (loss) per share	**$ (3.78)**	$ 3.48	$ 0.62

Consolidated Statement of Stockholders' Equity

Years Ended December 31, 1989, 1988 and 1987
(Thousands of dollars, except per share data)

	Common Stock		Capital In Excess	Retained
	Shares	Amount	of Par	Earnings
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
Net loss				(6,418)
Cash dividends, $6.00 per share				(10,188)
Balance December 31, 1989	1,698,024	$1,698	$15,364	$185,009

See notes to consolidated financial statements.

CONSOLIDATED STATEMENT OF CASH FLOWS

Years ended December 31, 1989, 1988 and 1987
(Thousands of dollars)

	1989	1988	1987
Cash flows from operating activities:			
Earnings (loss) before the cumulative effect of the change in accounting for income taxes	**$ (6,418)**	$ 766	$ 1,066
Adjustments to reconcile earnings (loss) to net cash provided (used) by operating activities:			
Depreciation	**11,215**	11,228	10,904
Deferred income tax provision (benefit)	**(3,841)**	(398)	409
Changes in assets and liabilities:			
(Increase) decrease in accounts receivable	**29**	2,176	(9,254)
Decrease in refundable income taxes	**2,508**	1,013	1,387
Increase in installment notes and contracts receivable	**(2,011)**	(3,212)	(2,760)
(Increase) decrease in inventories	**8,103**	(14,131)	(2,350)
Increase (decrease) in accounts payable	**(422)**	(841)	3,500
Increase (decrease) in accrued liabilities	**1,946**	(4,448)	561
Net cash provided (used) by operating activities	**11,109**	(7,847)	3,463
Cash flows from investing activities:			
Net additions to property, plant and equipment	**(5,166)**	(7,574)	(7,189)
Decrease in investments in marketable securities and other assets	**10,372**	6,186	17,498
Net cash provided (used) by investing activities	**5,206**	(1,388)	10,309
Cash flows from financing activities:			
Dividends paid	**(10,188)**	(11,941)	(13,664)
Stock purchased and retired	**—**	(1,450)	—
Net cash used by financing activities	**(10,188)**	(13,391)	(13,664)
Net increase (decrease) in cash and temporary investments	**6,127**	(22,626)	108
Cash and temporary investments, at beginning of year	**21,440**	44,066	43,958
Cash and temporary investments, at end of year	**$27,567**	$21,440	$44,066

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 $11,377,000 and $22,076,000 at December 31, 1989 and 1988, 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 company retains a secured interest in trailers sold on installment notes. The amounts due after one year ($24,724,000 at December 31, 1989 and $23,920,000 at December 31, 1988) are included in current assets.

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. Depreciation for financial reporting purposes is provided on a straight-line method based upon the estimated useful lives of the assets.

Expenditures for maintenance and repairs were $4,635,000 in 1989, $5,019,000 in 1988 and $4,063,000 in 1987.

Income taxes: A provision (benefit) is 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.

Other: Certain items have been reclassified in the 1988 and 1987 consolidated financial statements to conform with 1989 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 10%, 12% and 16% of net sales in 1989, 1988 and 1987, respectively.

(3) Income taxes

The income tax benefit for 1989, 1988 and 1987 consisted of the following:

(Thousands of dollars)	**1989**	1988	1987
Amounts currently refundable	**$ —**	$(1,085)	$(2,088)
Provision (benefit) of deferred taxes	**(3,841)**	(398)	409
	$(3,841)	$(1,483)	$(1,679)

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

(Thousands of dollars)	**1989**	1988	1987
Taxes computed at statutory rate	**$(3,488)**	$ (244)	$ (245)
Tax-exempt interest	**(206)**	(694)	(1,209)
Dividend income exclusion	**(145)**	(177)	(287)
Rate differential on NOL carryback to 1985	**—**	(332)	—
Other, net	**(2)**	(36)	62
Actual benefit	**$(3,841)**	$(1,483)	$(1,679)

The Company can no longer obtain refunds by carrying back current operating losses. However, the Company has reversed previously deferred income taxes. The future utilization of these loss carryforwards will result in the reinstatement of deferred income taxes.

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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(4) Inventories

Inventories used in determining cost of sales were as follows:

(Thousands of dollars)	1989	1988	1987	1986
Finished goods	**$12,470**	$11,087	$ 7,091	$ 6,205
Work in process	**7,330**	11,528	7,720	7,864
Raw material	**9,626**	14,914	8,587	6,979
	$29,426	$37,529	$23,398	$21,048

Had the first-in, first-out method been used in determining inventory values, inventories would have been $27,825,000, $27,809,000, $23,353,000 and $27,347,000 higher at December 31, 1989, 1988, 1987 and 1986, respectively.

During 1989 and 1987 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 decreased the net loss in 1989 by approximately $79,000 or $.05 per share and increased net earnings in 1987 by $520,000 or $.30 per share.

(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 the pension expense and disclosure requirements of Statement of Financial Accounting Standards No. 87, "Employers' Accounting for Pensions." The accounting change increased pre-tax earnings by approximately $1,575,000 for the year ended December 31, 1987.

Plan investment assets are invested primarily in equity securities, groups annuity contracts, corporate and United States debt securities and cash equivalents.

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

(Thousands of dollars)	1989	1988	1987
Components of pension (credit) expense			
Service cost	**$ 2,246**	$ 2,141	$ 1,704
Interest cost	**4,640**	4,638	4,350
Actual return on plan assets	**(14,448)**	(6,850)	(6,559)
Net amortization and deferral	**6,453**	(923)	(1,070)
Net pension credit	**$ (1,109)**	$ (994)	$ (1,575)
Plan assets at fair value	**$ 90,868**	$ 80,694	$ 78,750
Actuarial present value of			
projected benefit obligations			
Accumulated benefit obligations			
Vested	**(42,213)**	(42,506)	(43,282)
Nonvested	**(5,870)**	(5,659)	(4,927)
Provision for future salary increases	**(14,628)**	(14,359)	(9,981)
Plan assets over projected benefit obligations	**28,157**	18,170	20,560
Unrecognized transition gain	**(17,315)**	(18,242)	(19,168)
Unrecognized (gain) loss	**(7,224)**	2,578	104
Unrecognized prior service cost	**60**	63	79
Net prepaid pension cost	**$ 3,678**	$ 2,569	$ 1,575
Major assumptions at year-end			
Discount rate	**8%**	8%	8%
Rate of increase in compensation levels	**6%**	6%	6%
Expected long-term rate of return on plan assets	**9%**	9%	9%

The Company also has a defined contribution plan covering substantially all of its salaried employees. The Company makes contributions of 75% of employee contributions during the year. All obligations of the Company were funded currently through December 31, 1989. Pension expense for these plans totaled $628,000, $577,000 and $437,000 in 1989, 1988 and 1987, 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 Shareholders of Lufkin Industries, Inc.:

We have audited the accompanying consolidated balance sheets of Lufkin Industries, Inc. (a Texas corporation), and subsidiaries as of December 31, 1989 and 1988, and the related consolidated statements of earnings, stockholders' equity and cash flows for each of the three years in the period ended December 31, 1989. 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 amounts 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, 1989 and 1988, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1989 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 12, 1990

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

F.B. Stevenson, President, Chief Executive Officer

H.J. Green, Senior 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

Right: This conventional crank-balanced unit built in the mid-1950s has worked against a backdrop of more than 17,000 Montana sunsets

LUFKIN INDUSTRIES, INC.
P.O. Box 849 / Lufkin, Texas 75902