

1996

ANNUAL REPORT

LUFKIN

19

96

C O R P O R A T E P R O F I L E

The Company sells power transmission products, oil field pumping units, foundry castings and highway trailers throughout the world. The Company has vertically integrated all vital technologies required to design, manufacture and market its products. Lufkin's common stock is traded on The Nasdaq Stock Market (National Market) under the symbol LUFK.

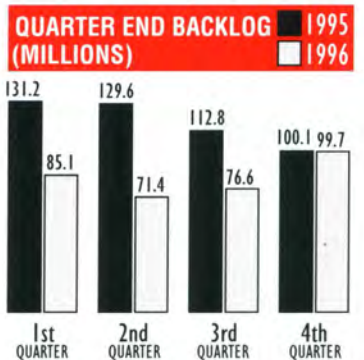
N O T I C E O F A N N U A L M E E T I N G

The Annual Meeting of Shareholders of Lufkin Industries, Inc. will be held at the Museum of East Texas, 503 North Second Street, Lufkin, Texas on May 7, 1997, at 9:00 a.m. local time.

FINANCIAL HIGHLIGHTS

(Thousands of dollars, except per share amounts)

	December 31,	
	1996	1995
Sales	\$225,974	\$248,909
Operating expenses	212,040	238,904
Earnings before income taxes	16,207	13,604
Net earnings	10,451	8,918
Earnings per share	1.56	1.31
Dividends per share	.60	.60
Total assets	185,925	186,296
Working capital	69,385	74,942
Shareholders' equity	144,607	142,592



1996 LETTER TO THE SHAREHOLDERS



Douglas V. Smith
President and Chief
Executive Officer

1996 was marked by the continued improvement of the Company's financial performance. Sales were down almost 10% due to a major downturn in demand for trailers, but profits were up in all other product lines. Our customer base was expanded in all areas, and our international presence was increased. We were successful in adapting to a different mix of products and were successful in achieving our goals for the year. We believe that this improvement will continue and that the outlook for 1997 is promising.

For the year ended December 31, 1996, net sales were \$226.0 million compared with \$248.9 million reported for the year ended December 31, 1995. Sales of power transmission products increased 22% to \$73.1 million compared with \$60.1 million in 1995. Power transmission sales benefited from stronger foreign markets. Oil field products sales rose 8% in 1996 to \$50.0 million from \$46.4 million in 1995 fueled in part by an improved price for oil around the world. Foundry castings products sales were up 2% to \$32.5 million from \$31.8 million a year ago. As anticipated, trailer products sales in 1996 were lower than in 1995 brought on by a decline in trailer orders and soft economic conditions affecting the trucking industry. For 1996, sales were \$70.4 million, a decrease of 36% from \$110.5 million in 1995. We are encouraged by the increase in order level during the year from the low point which occurred in the first quarter.

Operating income in 1996 increased 36% to \$14.3 million from \$10.5 mil-

lion in 1995. The increase reflects improvements in our operations to increase productivity and lower costs and a favorable mix effect of increased shipments of oil field and power transmission products. Cost of sales as a percentage of total sales decreased to 83.6% from 87.1% a year ago. Net income rose 18% to \$10.5 million compared with \$8.9 million, and earnings per share increased 19% to \$1.56 per share compared with \$1.31 per share, a year ago.

Lufkin's total backlog as of December 31, 1996, was \$99.7 million compared with \$76.6 million at the end of the third quarter in 1996 and \$100.1 million at the end of 1995. At year end, the backlog for oil field was \$12.1 million compared with \$8.1 million. The backlog was at its highest level since 1991 having increased sequentially in each of the last three quarters. The backlog at year end for trailers was \$40.1 million compared with \$40.2 million a year ago. The backlog showed significant improvement from the \$24.9 million level of the first quarter of 1996, and we have entered 1997 in a strong position. For foundry products, the backlog at year end was \$17.4 million compared with \$15.8 million and for power transmission products it was \$30.1 million compared with \$36.0 million a year ago.

The Company added to its sound financial position in 1996. Lufkin ended the year with total assets of \$185.9 million and working capital of \$69.4 million. Lufkin's shareholders' equity at year end was \$144.6 million, and the book value was \$22.05 per share. Cash and tempo-

rary investments totaled \$30.9 million, and Lufkin had no outstanding debt at year end.

To increase the value of the Company's common stock, the Board of Directors authorized the use of up to \$4.0 million for the repurchase of shares of Lufkin's common stock during 1996. As of December 31, 1996, a total of 238,000 shares have been repurchased under the Company's repurchase programs. The current repurchase program is the Company's third such program. It is the Board's belief that periodic repurchase of common stock of Lufkin represents a sound use of a portion of available cash.

Lufkin paid four quarterly cash dividends of \$0.15 per share on the Company's common stock for a total of \$0.60 per share paid in 1996. Effective with the first quarter of 1997, the quarterly dividend was increased 13% to \$0.17 per share. Lufkin has paid a quarterly cash dividend for 57 consecutive years.

During 1996 Lufkin was able to strengthen its market position within each of its product lines. We accomplished this by:

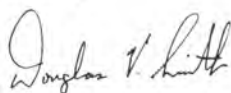
- Introducing new trailer products
- Developing new gearing in direct support of the power generation market
- Extending our international sales presence
- Installing new iron melting capability for engineered castings
- Increasing our customer support of oil field markets
- Improving operational capability and performance
- Providing enhanced training for employees.

Our plan for the future is to continue to focus on investment opportunities where we can capitalize on Lufkin's expertise within engineered industrial products based in metalworking, strengthen our superior customer service and improve the support facilities of all our product lines.

Lufkin's growth and financial performance is clearly supported by an excellent organization structure. We are proud to employ some of the most experienced and highly regarded people in our industry and to have the necessary financial resources to achieve continued improvement. Our goal for 1997 is to see that all Lufkin's stakeholders share in the increased performance it achieves.

Overall, we are very pleased with the results Lufkin achieved during the past year. We are encouraged about the trends affecting our product lines, particularly for oil field and trailer products and remain optimistic about reporting 1997 results that compare favorably with 1996.

Sincerely,



Douglas V. Smith
President and Chief Executive Officer

1996 OIL FIELD



Sales to international markets, including Australia, accounted for over 50 percent of total oil field sales in 1996.

Overall demand for oil field pumping units in 1996 increased 8.0% over the 1995 level. This improvement was fueled by increased global investment in oil production. Shipments in the domestic market increased 14% in 1996. Increased domestic drilling and the tight availability of used pumping units accounted for the improved demand. The 1997 domestic outlook is expected to continue to expand.

Revenue in Canada, where the government continues to stress incentives to drill for natural gas and oil, increased 35% in 1996. The increase in Canada was offset primarily by a slow down in Argentina. For 1997, we are expecting sales in Canada to remain strong, a rebound in South America, and improved sales in the Eastern Hemisphere.

The Company's presence in key South American, Far East, and Canadian markets with local manufacturing capabilities provides the Company with the ability to meet local demand with faster deliveries and prices competitive with local economic conditions. This in-country presence also allows the Company to provide technical support as well as field service which gives the Company an additional competitive advantage.

With the completion of a factory consolidation project at the main manufacturing facility during the third quarter of 1996, the division

is positioned with improved work flow, more efficient material handling, and new machine tool technology which will further reduce costs and improve productivity.

The oil field division ended 1996 in a strong position. The backlog was \$12.1 million, a 49% increase from \$8.1 million at the end of 1995. The increase in the average oil price (20% up over 1995) is generally expected to result in higher investments by the oil industry in 1997. Prices for oil field equipment are expected to outpace inflation. As a result, revenues are anticipated to show continued improvement; and the combination of stronger prices, reduced cost, and leverage on increased volume should yield improved financial performance in 1997.

Longer term, the future for the type of oil field equipment Lufkin manufactures is positive. The oil industry is in better economic shape than it has been since 1981. Demand for oil continues to increase, and the ratio of supply to demand for oil is supporting an oil price more stable than in the past 15 years. The investments by the Company's customers in the business continues to grow. As the major supplier worldwide, Lufkin is ready to meet the needs as the market continues to expand.

Lufkin Industries serves its world-wide markets with a full range of products. At right is a conventional crank-balanced unit in Australia's Barrow Island. Shown below is a Mark II unit in Turner Valley, Alberta, Canada.



OIL FIELD



1996

POWER TRANSMISSION

Power transmission enjoyed one of its best years in 1996 with revenues rising 22% over 1995. This marked the fifth consecutive year of revenue growth for the division. Earnings were also up significantly, due to both added volume and improvements in productivity.

While demand was strong in virtually all segments of power transmission's business, there was some softening mid-year in bookings in both the power generation and petrochemical segments. These were offset by growth in demand for gears used in the steel and marine industries. In addition, orders received from new international accounts provided new opportunities and countered the effect of the temporary drop in demand in the power generation and petrochemical sectors. Demand strengthened in these two markets during the fourth quarter, and the outlook for 1997 is strong.

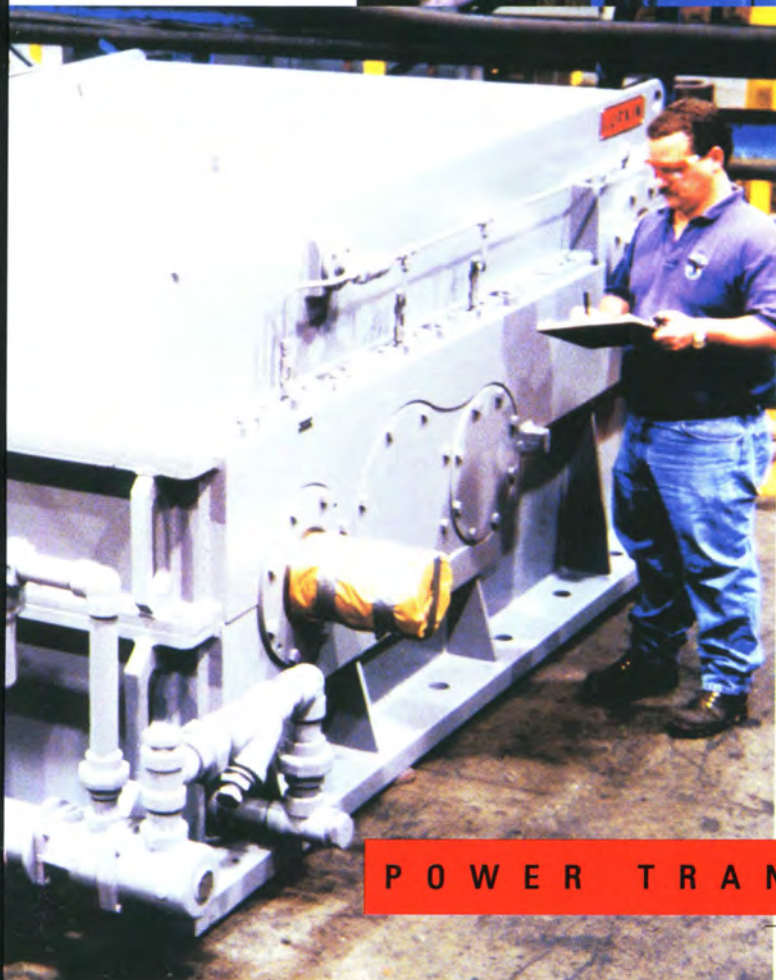
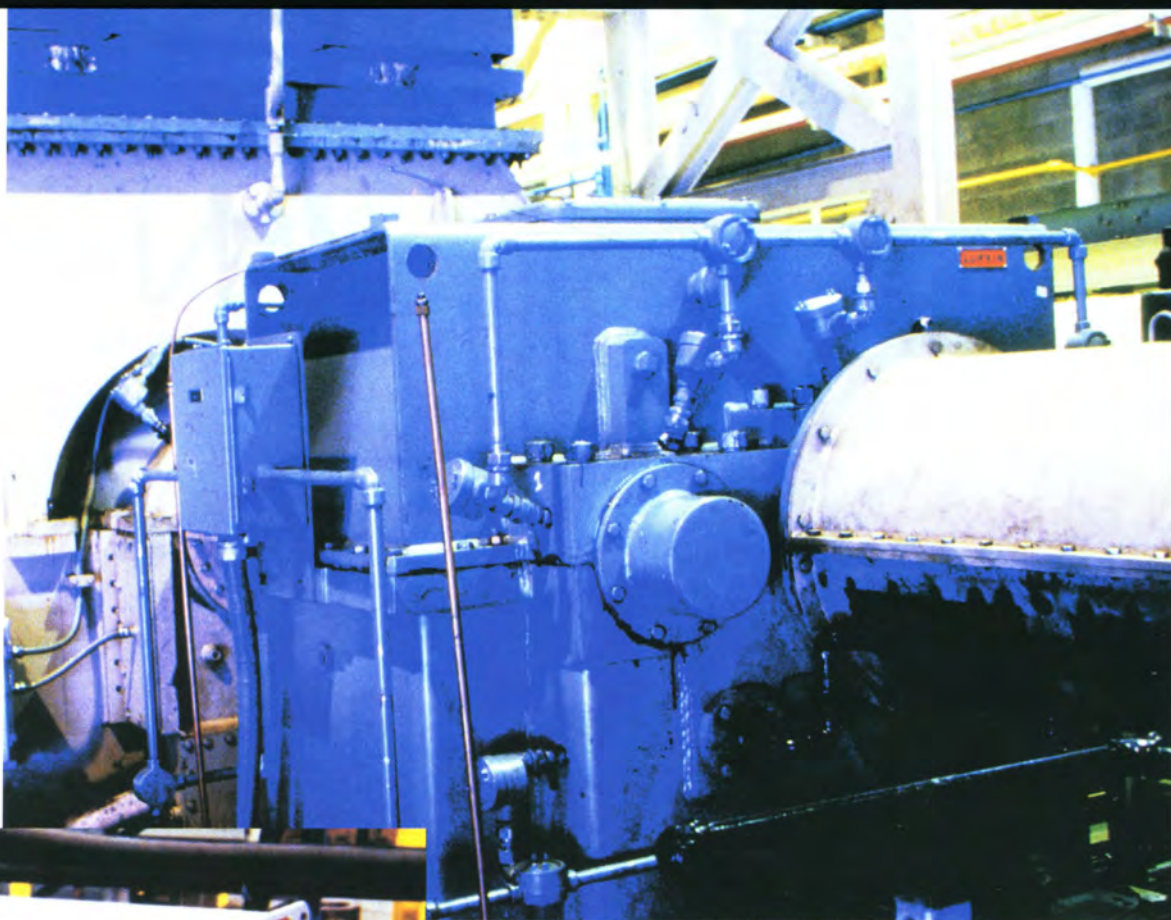
The demand for gears in the power generation sector will grow from the need for electrical power generation in developing countries and the continuing move to combined cycle operations in industrialized countries. The petrochemical sector will respond to continued investment in new plants in developing countries, as well as the drive to update existing refineries and petrochemical plants to improve efficiency and address the ongoing safety and environmental requirements.

Lufkin's products and services are ideally positioned to compete successfully as its major markets continue their trend of steady growth. Product development efforts have yielded significant improvements in product performance, while investments in both capital equipment and training have improved operational efficiency.

Lufkin's sales and services coverage are recognized as among the best in the industry. Efforts in 1997 will be directed at strong customer support as the primary strategy for growth in those sectors that offer attractive returns, coupled with a strong focus on operational and quality improvement in our design and manufacturing activities.



Our global growth continued into 1997 with the opening of our new sales office in Kobe, Japan.



Lufkin is a major supplier of equipment to the power generation industry. The unit shown above transmits 30,000 horsepower from a gas turbine to an electric generator. The unit shown at left is one of several custom-designed units manufactured for a major steel mill expansion project. It is undergoing a final quality assurance inspection before shipment.

POWER TRANSMISSION



1996

FOUNDRY CASTINGS



Lufkin's foundry castings are used in various products around the globe. The construction equipment industry is one of several industries served by Lufkin's foundry.

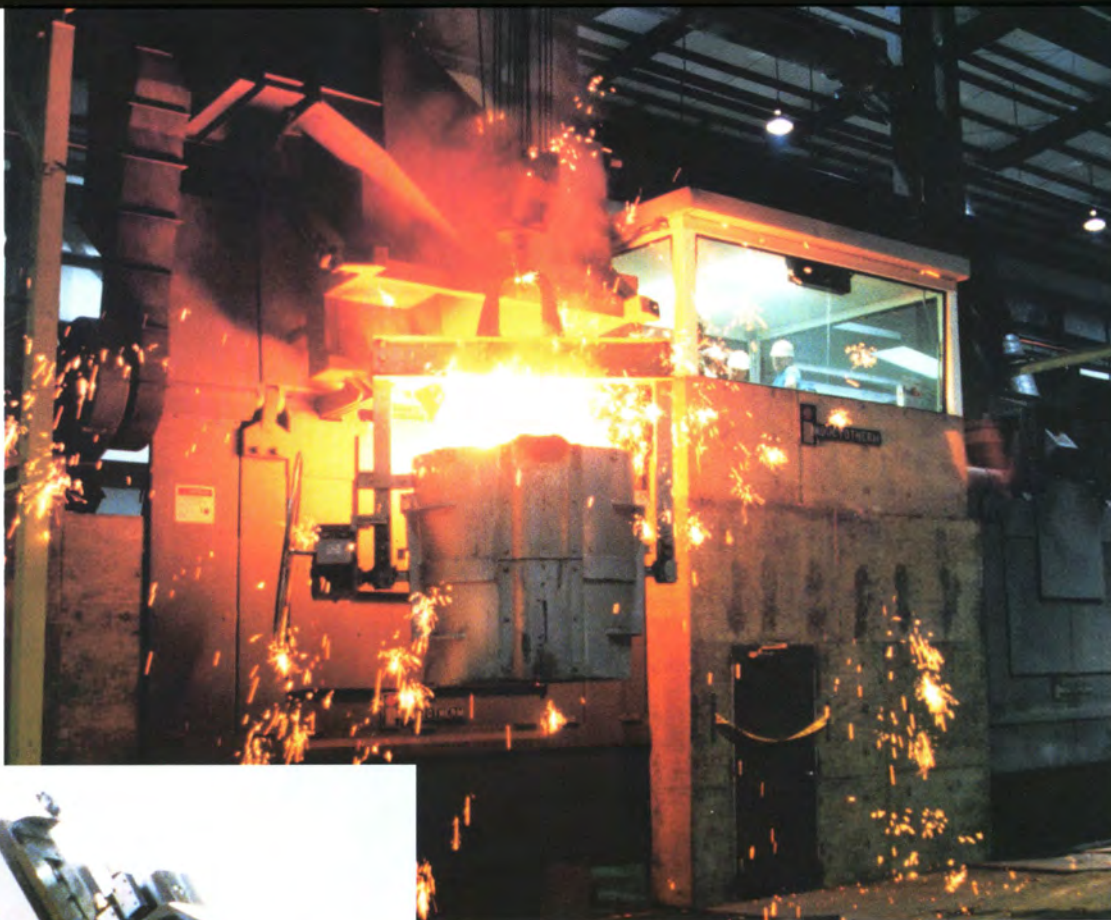
Lufkin's foundry division experienced continued strong demand from commercial castings during 1996. The division again achieved a new cupola tonnage record of charging over 67,000 tons of ductile and gray iron. This was approximately 200 tons above the record set during 1995. While continuing to operate at near capacity levels, revenues also increased modestly due to some product mix shift to higher value-added engineered castings.

Lufkin's casting capabilities include low-to medium-volume ductile and gray iron castings which are used as components for numerous original equipment manufacturers (OEMs). Over 300 tons of iron are poured each production day for castings ranging in size from 100 pounds to over 30,000 pounds. This capacity ranks Lufkin as one of the largest suppliers in the United States.

The foundry's customer base expanded during the past several years to include such industrial sectors as building construction equipment, material handling equipment, machine tools, valves and water works, pump and compressor, as well as heavy truck suspension manufacturers. Lufkin's casting products can be found in such diverse applications as strainer bodies for fire protection systems, bridge support bearings, horizontal and vertical CNC machining centers, or front-end loaders working in quarries.

In 1997, Lufkin's efforts will remain focused on expanding the more technically demanding, higher value-added engineered castings. The strategy will allow for the continued development of profitable, long-term relationships with strategic customers while remaining focused on unsurpassed customer service. These efforts will be maintained while continuing to support Lufkin's power transmission and oil field divisions where it is economically advantageous.

Right: As part of its foundry expansion program, Lufkin installed two new coreless induction furnaces. The furnaces, which were put into operation in February 1997, have a capacity of 10 metric tons each. Below is an example of Lufkin's engineered castings. Lufkin produces the bed and the carriage for this heavy-duty CNC turning center.

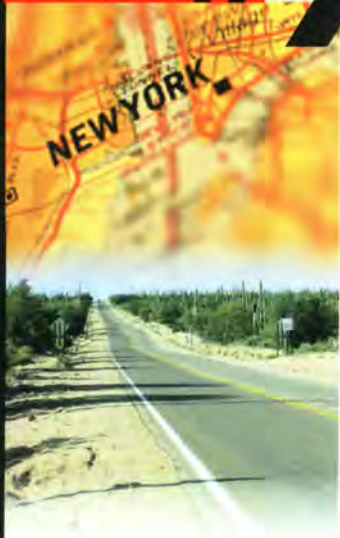


FOUND RY C A S T I N G S



TRAILERS

1996



All over the US highways, Lufkin trailers can be seen carrying a variety of goods.

While overall economic conditions in 1996 were generally favorable in most of Lufkin's markets, the factors directly affecting the transportation industry were negative. The trailer industry saw consolidation among its participants and some of the weaker companies falling by the wayside. The decline experienced in 1996 was moderated as a result of the strategy Lufkin implemented in 1995 to position itself for an anticipated downturn in the trailer market by bringing its production capability and workforce in line with expected demand. Although financial performance in the trailer division was depressed from record levels of the past two years, 1996 was a good, steady business year in which Lufkin had several noteworthy achievements.

During the past year, Lufkin was able to expand its customer base by making a concerted effort to reach a greater number of users and dealers. This action lessened the dependency on its largest customers and showed positive results. Lufkin's reputation for quality construction, reliability, innovation of design, and competitive prices has helped it expand the customer base. Also, Lufkin's solid financial base made it a more reliable supplier in the financially distressed trailer industry.

During the past year the trailer division added to its diverse product offering by introducing a new open-top chip trailer. In addition, the new

plate trailer introduced in 1995 went into full production and has been well received by customers. The many different sizes and styles of vans, platforms, and high capacity and lightweight dump trailers have tended to minimize the risk associated with dependency on one type of trailer.

With the economy holding steady, the trailer division is expected to benefit from growth in the demand for trailers. The division is focused on continuing to improve productivity and is well positioned to capitalize on opportunities to increase market share. Lufkin's established manufacturing facilities provide ample capability to meet short-term supply. On a long-term basis, several favorable trends are expected to increase the demand for trailers. One, the average age of trailer fleets is increasing. Secondly, more companies are outsourcing their transportation needs. And, third, more trailers are being used as warehouses for short-term storage. These industry trends should favorably impact the trailer division.

Lufkin meets the needs of its trailer customers with innovative products. At right is Lufkin's new open-top van which was designed with aerodynamic and weight saving features to increase productivity of customers in the wood products industry. Shown below is a special drop-frame platform trailer manufactured for use at space shuttle launching sites. This trailer carries sensitive equipment for pre-launch loading.



TRAILERS



1996 FINANCIAL SECTION

FINANCIAL REVIEW

Lufkin Industries, Inc. and Subsidiaries

Common Stock Information

Quarter	1996			1995		
	Stock Price		Dividend	Stock Price		Dividend
	High	Low		High	Low	
First	\$22.50	\$17.00	\$.15	\$18.50	\$16.63	\$.15
Second	21.75	18.00	.15	20.00	18.00	.15
Third	21.25	18.00	.15	23.50	18.50	.15
Fourth	25.25	20.75	.15	23.50	18.50	.15

The Company's common stock is traded on The Nasdaq Stock Market (National Market) under the symbol LUFK and as of February 28, 1997, there were approximately 800 record holders of its common stock.

The Company has paid cash dividends for 57 consecutive years. Total dividend payments were \$3,993,000 and \$4,071,000 in 1996 and 1995, respectively.

Quarterly Financial Data (Unaudited)

In millions, except per share data	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
1996				
Net sales	\$55.9	\$55.6	\$55.1	\$59.4
Gross margin	8.8	9.9	8.9	9.5
Net earnings	2.4	2.9	2.5	2.6
Earnings per share	.36	.43	.38	.39
1995				
Net sales	\$59.0	\$58.6	\$62.9	\$68.4
Gross margin	6.7	8.4	8.3	8.8
Net earnings	1.6	2.4	2.1	2.8
Earnings per share	.24	.36	.31	.40

Additional Financial Information

Stockholders may obtain additional information for the year ended December 31, 1996, 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 75902-0849.

Results of operations

Net sales for 1996 were \$226.0 million compared to \$248.9 million for 1995 and \$217.3 million for 1994. The Company reported net operating income of \$14.3 million and \$10.5 million for 1996 and 1995, respectively. In 1994, the Company had an operating loss of \$3.1 million. For 1996, the Company reported net income of \$10.5 million, compared to a net income of \$8.9 million for 1995 and a net loss of \$1.2 million for 1994. The 1994 results included an \$11.2 million pre-tax charge for special inventory write-downs.

During 1996, the Company experienced a decline in trailer revenues while revenues for all other product groups increased. The annual percentage increases (decreases) in revenues for the Company's product groups for the three years ended December 31, 1996 were as follows:

	Annual increases (decreases) in revenues		
	1996	1995	1994
Oil field pumping units	8%	13%	(30)%
Power transmission products	22	9	16
Foundry castings	2	5	25
Trailers	(36)	26	37
Total company	(9)%	15%	7%

The sales mix of the Company's products for the three years ended December 31, 1996 was as follows:

	Percent of total sales		
	1996	1995	1994
Oil field pumping units	22%	19%	19%
Power transmission products	32	24	25
Foundry castings	15	13	14
Trailers	31	44	41
Other	-	-	1
Total company	100%	100%	100%

Oil field revenues increased 8% to \$50.0 million in 1996 over 1995 revenues of \$46.4 million. Oil field revenues were \$40.9 million in 1994. During 1996, the Company booked new orders of \$54.0 million compared to \$47.3 million in 1995 and \$42.9 million in 1994. Demand for oil field products increased at the end of 1996 resulting in a backlog for oil field products at December 31, 1996 of \$12.1 million, its highest level since 1991. At December 31, 1995 and December 31, 1994, the backlog for oil field products was \$8.1 million and \$8.5 million, respectively.

Sales of power transmission products increased 22% to \$73.1 million from sales of \$60.1 million in 1995. Power transmission sales for 1994 were \$55.3 million. New order bookings totaled \$67.2 million for 1996 compared to \$75.5 million and \$54.0 million for 1995 and 1994, respectively. At December 31, 1996, the power transmission backlog was \$30.1 million compared to \$36.0 million at the end of 1995 and \$21.1 million at year end 1994.

Foundry castings revenues increased to \$32.5 million for 1996, up 2% from 1995. Sales of foundry castings were \$31.8 million in 1995 and \$30.2 million in 1994. New order bookings totaled \$34.0 million in 1996 and 1995. The backlog for foundry castings at December 31, 1996 was \$17.4 million compared to \$15.8 million and \$4.2 million at the end of 1995 and 1994, respectively.

The Company's trailer product sales decreased by 36% to \$70.4 million from \$110.5 million in 1995 due to decreased sales volumes as a result of lower trailer market demand levels. Trailer products sales in 1994 were \$87.8 million. New trailer orders booked during 1996 totaled \$70.3 million compared to \$79.0 million in 1995 and \$112.4 million in 1994. At the end of 1996, the trailer backlog was \$40.1 million compared to \$40.2 million at December 31, 1995 and \$75.6 million at December 31, 1994.

Gross profit margins before special inventory write-downs increased to 16% for 1996 from 13% for 1995 and 1994. The 1996 sales mix reflected increased sales in the higher margin oil field and power transmission product lines

MANAGEMENT'S DISCUSSION AND ANALYSIS

while lower margin trailer sales decreased. In addition, the Company continued to emphasize cost awareness and cost reduction programs.

Selling, General and Administrative (S. G. & A.) expenses were \$23.2 million in 1996 compared to \$22.2 million and \$20.7 million in 1995 and 1994, respectively. The increase in SG & A expenses was due primarily to increased power transmission selling expenses associated with expansion of the Company's selling efforts and market presence in western Europe and other areas.

Net operating income for 1996 was \$14.3 million. The Company realized net operating income of \$10.5 million in 1995 and a net operating loss of \$3.1 million in 1994. The Machinery Division's net operating income as a percentage of sales before special inventory writedowns was 6% for 1996 compared to 2% for 1995 and 1% in 1994. The increase reflects improved product mix and increased sales volumes in Machinery Division products. The Trailer Division's net operating income as a percentage of sales was 6% for 1996, down from 7% for 1995 and 1994. The decrease in net operating income for the Trailer Division was due to decreased sales volumes partially offset by cost reductions in the area of fixed costs.

Other income was \$.3 million in 1996 compared to \$.5 million in 1995. Investment income decreased in 1996 to \$1.9 million from \$3.1 million in 1995. The decrease in investment income was due to lower investment balances resulting in decreased interest income. In addition, capital gains on investments were lower in 1996 than 1995.

Net income was increased by approximately \$.4 million (\$.06 per share) for 1996 and was reduced by approximately \$1.0 million (\$.15 per share), for 1995, as a result of using the LIFO method as compared to the FIFO method of accounting for certain inventories. During 1996 and 1994, LIFO inventories were reduced and these reductions resulted in a liquidation of LIFO inventory quantities carried at lower costs prevailing in prior years. The impact of these LIFO inventory liquidations increased net income in 1996 and reduced the net loss in 1994 by approximately \$.1 million (\$.02 per share) and \$3.6 million (\$.53 per share), respectively.

Liquidity and capital resources

At December 31, 1996, the Company had working capital of \$69.4 million compared to \$74.9 million in 1995 and \$70.8 million in 1994. The Company generated \$19.1 million net cash from operating activities in 1996. Net cash provided from operating activities in 1995 and 1994 was \$7.4 million and \$20.7 million, respectively. Accounts receivable decreased by 7.5% to \$33.5 million from \$36.2 million at the end of 1995 primarily as a result of decreased sales volumes. At December 31, 1996 inventories were \$3.2 million lower and accounts payable were \$4.4 million lower than the December 31, 1995 balances. These decreases were primarily due to the lower sales volumes of trailer products in 1996. Dividends of \$.60 per share totaling \$4.0 million were paid in 1996. During 1995 and 1994, dividends totaled \$4.1 million (\$.60 per share) each year. During 1996, the Company's expenditures for property, plant and equipment (PP & E) totaled \$12.4 million related to capacity expansions in the foundry and power transmission repair businesses, equipment replacement and business consolidation. PP&E expenditures for 1995 and 1994 totaled \$7.6 million and \$5.2 million, respectively. Treasury stock purchases increased to \$4.4 million in 1996 over \$4 million in 1995. Under the Company's current stock repurchase program authorizations of approximately \$1.3 million remained at December 31, 1996 for future treasury stock purchases. The Company believes that existing working capital will be sufficient to satisfy its 1997 requirements. In recent years, capital expenditures have been financed with internally generated funds, and the Company plans to finance future improvements of its facilities in this manner. No significant commitments were outstanding at December 31, 1996.

The Internal Revenue Service (IRS) has examined the Company's federal income tax returns for calendar years 1991 through 1993. The IRS has recommended an assessment of additional taxes for 1991 and 1993. The Company disagrees with the IRS' position and is currently pursuing its rights of administrative review and appeal and intends to vigorously contest this matter. Although the resolution of these remaining issues could affect the timing of the payment of previously accrued tax liabilities and require the use of a portion of its available capital, the Company does not believe that the results of the audit or the ultimate resolution of the IRS' proposed adjustments will have a material impact on its consolidated results of operations or financial position.

Forward-looking statements and assumptions

This Annual Report may contain or incorporate by reference certain forward-looking statements, including by way of illustration and not of limitation, statements relating to liquidity, revenues, expenses, margins and contract rates and terms. The Company strongly encourages readers to note that some or all of the assumptions, upon which such forward-looking statements are based, are beyond the Company's ability to control or estimate precisely, and may in some cases be subject to rapid and material changes.

C O N S O L I D A T E D B A L A N C E S H E E T

Lufkin Industries, Inc. and Subsidiaries

December 31, 1996 and 1995
(Thousands of dollars except share data)

Assets	1996	1995
Current assets:		
Cash	\$ 655	\$ 277
Temporary investments	30,211	33,040
Receivables, net	33,472	36,204
Inventories	21,563	24,737
Deferred income taxes	2,132	3,853
Total current assets	88,033	98,111
Property, plant and equipment, net	65,993	60,823
Prepaid pension costs	24,469	20,936
Other assets	7,430	6,426
Total assets	\$185,925	\$186,296
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	\$ 7,035	\$ 11,430
Accrued liabilities:		
Payroll and benefits	5,050	5,084
Accrued warranty expenses	1,329	2,032
Taxes payable	3,072	2,849
Commissions and other	2,162	1,774
Total current liabilities	18,648	23,169
Deferred income tax	10,478	8,500
Post retirement benefits	12,192	12,035
Shareholders' equity:		
Common stock, par \$1 per share; 20,000,000 shares authorized; 6,792,381 shares issued	6,792	6,792
Capital in excess of par	15,367	15,367
Retained earnings	128,150	121,692
Treasury Stock, 233,998 shares and 16,108 shares, at cost	(4,754)	(311)
Cumulative translation adjustment	(948)	(948)
Total shareholders' equity	144,607	142,592
Total liabilities and shareholders' equity	\$185,925	\$186,296

See notes to consolidated financial statements.

C O N S O L I D A T E D S T A T E M E N T O F E A R N I N G S

Lufkin Industries, Inc. and Subsidiaries

Years ended December 31, 1996, 1995 and 1994
(Thousands of dollars, except per share data)

	1996	1995	1994
Sales	\$225,974	\$248,909	\$217,273
Costs and expenses:			
Cost of sales	188,877	216,733	189,999
Selling, general and administrative expenses	23,163	22,171	20,725
Special inventory provisions	-	-	11,224
Other income, net	(345)	(481)	(1,610)
Total costs and expenses	211,695	238,423	220,338
Operating income (loss)	14,279	10,486	(3,065)
Investment income	1,928	3,118	1,266
Earnings (loss) before income taxes	16,207	13,604	(1,799)
Income taxes (benefits)	5,756	4,686	(592)
Net earnings (loss)	\$ 10,451	\$ 8,918	\$ (1,207)
Net earnings (loss) per share	\$ 1.56	\$ 1.31	\$ (.18)

See notes to consolidated financial statements.

CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

Lufkin Industries, Inc. and Subsidiaries

Years ended December 31, 1996, 1995 and 1994
(Thousands of dollars, except share and per share data)

	Common Shares	Stock Amount	Capital In Excess Of Par	Retained Earnings	Treasury Stock	Cumulative Translation Adjustment
Balance December 31, 1993	6,792,381	\$6,792	\$15,372	\$122,127		\$(800)
Net loss				(1,207)		
Cash dividends, \$.60 per share				(4,075)		
Foreign currency translation adjustment						(245)
Balance December 31, 1994	6,792,381	6,792	15,372	116,845		(1,045)
Net earnings				8,918		
Cash dividends, \$.60 per share				(4,071)		
Foreign currency translation adjustment						97
Purchases of treasury stock (20,108 shares)					(384)	
Exercise of stock options (4,000 shares)			(5)		73	
Balance December 31, 1995	6,792,381	6,792	15,367	121,692	(311)	(948)
Net earnings				10,451		
Cash dividends, \$.60 per share				(3,993)		
Purchases of treasury stock (218,015 shares)					(4,445)	
Exercise of stock options (125 shares)					2	
Balance December 31, 1996	6,792,381	\$6,792	\$15,367	\$128,150	\$(4,754)	\$(948)

See notes to consolidated financial statements.

CONSOLIDATED STATEMENT OF CASH FLOWS

Lufkin Industries, Inc. and Subsidiaries

Years ended December 31, 1996, 1995 and 1994
(Thousands of dollars)

	1996	1995	1994
Cash flow from operating activities:			
Net earnings (loss)	\$ 10,451	\$ 8,918	\$ (1,207)
Adjustments to reconcile earnings (loss) to net cash provided by operating activities:			
Depreciation	6,950	7,050	7,895
Deferred income tax provision	3,699	2,997	28
Pension income	(3,533)	(3,151)	(3,628)
Post retirement benefits	157	192	216
Gain on sales of property, plant and equipment	(45)	(247)	(1,299)
Changes in:			
Receivables	2,732	(7,942)	9,341
Inventories	3,174	(2,818)	11,239
Accounts payable	(4,395)	769	796
Accrued liabilities	(126)	1,605	(2,677)
Net cash provided by operating activities	19,064	7,373	20,704
Cash flows from investing activities:			
Additions to property, plant and equipment	(12,357)	(7,646)	(5,238)
Proceeds from disposition of property, plant and equipment	282	725	5,356
(Increase) decrease in other assets	(1,004)	232	66
Net cash provided (used) by investing activities	(13,079)	(6,689)	184
Cash flows from financing activities:			
Dividends paid	(3,993)	(4,071)	(4,075)
Proceeds from exercise of stock options	2	68	-
Purchase of treasury stock	(4,445)	(384)	-
Net cash used by financing activities	(8,436)	(4,387)	(4,075)
Effect of translation on cash and temporary investments	-	97	(245)
Net increase (decrease) in cash and temporary investments	(2,451)	(3,606)	16,568
Cash and temporary investments, at beginning of year	33,317	36,923	20,355
Cash and temporary investments, at end of year	\$ 30,866	\$ 33,317	\$ 36,923

See notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Lufkin Industries, Inc. and Subsidiaries

(1) Summary of major accounting policies

Principles of consolidation: The consolidated financial statements include the accounts of Lufkin Industries, Inc. and Subsidiaries (the Company) after elimination of all significant intercompany accounts and transactions.

Use of estimates: The preparation of the financial statements in conformity with generally accepted accounting principles requires the use of certain estimates by management in determining the Company's assets, liabilities, revenue and expenses.

Translation of foreign currencies: Assets and liabilities of foreign operations are translated into U.S. dollars at the exchange rate in effect at the end of each accounting period and income statement accounts are translated at the average exchange rates prevailing during the period.

Temporary investments: The Company's temporary investments consisting of highly liquid government and corporate debt securities have been classified as trading securities which are carried at market value. All realized and unrealized gains and losses are recognized currently in investment income.

Receivables: The following is a summary of the Company's receivable balances:

(Thousands of dollars)	1996	1995
Accounts receivable	\$31,586	\$34,645
Notes receivable	2,486	2,159
	34,072	36,804
Allowance for doubtful accounts	(600)	(600)
Net receivables	\$33,472	\$36,204

Inventories: The Company reports its inventories by using the last-in, first-out (LIFO) and the first-in, first-out (FIFO) methods less reserves necessary to report inventories at the lower of cost or estimated market. 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. Accelerated depreciation methods are used for tax purposes. The following is a summary of the Company's property, plant and equipment balances and useful lives.

(Thousands of dollars)	Useful Life in Years	1996	1995
Land	-	\$ 2,800	\$ 2,819
Land Improvements	10-25	6,015	5,965
Buildings	12.5-40	54,339	52,555
Machinery and equipment	3-12.5	162,542	155,702
Furniture and fixtures	5-12.5	17,318	16,735
Total property, plant and equipment		243,014	233,776
Less accumulated depreciation		(177,021)	(172,953)
Total property, plant and equipment, net		\$ 65,993	\$ 60,823

The Company applies Statement of Financial Accounting Standards (SFAS) No. 121 for recognition of a loss if impairment occurs in its fixed assets. The adoption of this policy in 1996 had no impact on the Company's results of operations or financial condition.

Earnings per share: Earnings per share amounts are based on the weighted average number of shares of common stock and common stock equivalents outstanding during the period. The weighted average number of shares used to compute earnings per share was 6,714,812 shares, 6,823,776 shares, and 6,792,381 shares for 1996, 1995, and 1994, respectively.

Other: Certain prior year amounts have been reclassified to conform with the current year presentation.

Income taxes: The Company follows Statement of Financial Accounting Standards (SFAS) No. 109 "Accounting for Income Taxes". Under SFAS No. 109, deferred tax assets or liabilities are recorded based on the difference between the financial statement and income tax bases of assets and liabilities using enacted tax rates.

(2) Income taxes

The net deferred income tax liabilities are comprised of the following:

(Thousands of dollars)	1996	1995
Current deferred income tax assets		
Gross assets	\$ 3,404	\$ 5,300
Gross liabilities	(1,272)	(1,447)
Total, net	2,132	3,853
Noncurrent deferred income tax liabilities		
Gross assets	8,245	6,715
Gross liabilities	(18,723)	(15,215)
Total, net	(10,478)	(8,500)
Net deferred income tax liabilities	\$ (8,346)	\$ (4,647)

The tax effects of significant temporary differences representing deferred tax assets and liabilities are as follows:

(Thousands of dollars)	1996	1995
Inventories	\$ 156	\$ 1,732
Prepaid pension costs	(8,564)	(7,336)
Payroll and benefits	1,073	1,174
Accrued warranty expenses	465	711
Post retirement benefits	4,267	4,212
Capital loss and tax credit carryforwards	1,598	2,509
Depreciation	(7,387)	(7,053)
Other, net	46	(596)
Net deferred income tax liabilities	\$ (8,346)	\$ (4,647)

The income tax provision (benefit) for 1996, 1995, and 1994 consisted of the following:

(Thousands of dollars)	1996	1995	1994
Current	\$2,057	\$1,689	\$(620)
Deferred	3,699	2,997	28
Total	\$5,756	\$4,686	\$(592)

A reconciliation of the income tax provision (benefit) as computed at the statutory U.S. income tax rate and the income tax provision (benefit) presented in the consolidated financial statements is as follows:

(Thousands of dollars)	1996	1995	1994
Tax provision (benefit) computed at statutory rate	\$5,672	\$4,693	\$(612)
Tax effect of:			
Expenses for which no benefit was realized	362	271	-
Tax-exempt interest and dividend income exclusion	(158)	(170)	(72)
Other, net	(120)	(108)	92
Actual provision (benefit)	\$5,756	\$4,686	\$(592)

Cash payments for income taxes totaled \$2,178,000, \$2,292,000 and \$235,000 for 1996, 1995 and 1994, respectively.

For income tax reporting purposes at December 31, 1996, the Company has alternative minimum tax carryforwards of \$785,000 and foreign tax credit carryforwards of \$796,000.

The Internal Revenue Service (IRS) has examined the Company's federal income tax returns for calendar years 1991 through 1993. The IRS has recommended an assessment of additional taxes for 1991 and 1993. The Company disagrees with the IRS' position and is currently pursuing its rights of administrative review and appeal and intends to vigorously contest this matter. Although the resolution of these remaining issues could affect the timing of the payment of previously accrued tax liabilities and require the use of a portion of its available capital, the Company does not believe that the results of the audit or the ultimate resolution of the IRS' proposed adjustments will have a material impact on its consolidated results of operations or financial position.

(3) Inventories

Inventories used in determining cost of sales were as follows:

(Thousands of dollars)	1996	1995
Finished goods	\$ 5,898	\$6,845
Work in process	4,566	6,050
Raw materials	11,099	11,842
Total	\$21,563	\$24,737

Inventories accounted for on a LIFO basis were \$16,655,000 and \$19,258,000 and on a FIFO basis were \$4,908,000 and \$5,479,000 at December 31, 1996 and 1995, respectively. Had the FIFO method been used in determining all inventory values, inventories would have been \$17,624,000 and \$18,194,000 higher at December 31, 1996 and 1995, respectively.

Net income was increased by approximately \$.4 million (\$.06 per share) for 1996 and was reduced by approximately \$1.0 million (\$.15 per share), for 1995, as a result of using the LIFO method as compared to the FIFO method of accounting for certain inventories. During 1996 and 1994, LIFO inventories were reduced and these reductions resulted in a liquidation of LIFO inventory quantities carried at lower costs prevailing in prior years. The impact of these LIFO inventory liquidations increased net income in 1996 and reduced the net loss in 1994 by approximately \$.1 million (\$.02 per share) and \$3.6 million (\$.53 per share), respectively.

(4) Employee stock option plan

The Company's 1990 Stock Option Plan provides for the granting of options to key employees to purchase an aggregate of not more than 900,000 shares of the Company's stock at fair market value on the date of grant. One fourth of granted options generally become exercisable after one year and each year thereafter. The options may not be exercised after ten years from the date of grant. Outstanding options may be cancelled and reissued under terms specified in the plan.

The following table summarizes activity under the Company's stock option plan:

	1996	1995	1994
Options outstanding, beginning of year	447,965	355,465	260,715
Granted (per share)			
1994 (\$15.875 to \$18,625)			94,750
1995 (\$19.00 to \$20.00)		97,500	
1996 (\$18.125 to \$21.75)	106,150		
Exercised (per share)			
1995 (\$15.31 to \$17.50)		(4,000)	
1996 (\$15.875)	(125)		
Forfeited (per share)			
1995 (\$30.00)		(1,000)	
1996 (\$15.875 to \$20.00)	(3,000)		
Options outstanding, end of year	550,990	447,965	355,465

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The Company accounts for its stock option plan under APB opinion No. 25 under which no compensation cost has been recognized. Had compensation cost for these plans been determined consistent with SFAS Statement No. 123, "Accounting for Stock-Based Compensation", the Company's net income and earnings per share would have been reduced to the following pro forma amounts, (in thousands except per share data):

		1996	1995
Net Earnings	As reported	\$10,451	\$8,918
	Pro forma	\$10,316	\$8,897
Earnings Per Share	As reported	\$1.56	\$1.31
	Pro forma	\$1.54	\$1.30

The effects of applying SFAS No. 123 in the pro forma disclosure may not be indicative of future amounts. SFAS No. 123 does not apply to options awarded prior to 1995, and additional awards in future years are anticipated. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

Expected dividend yield	2.8% - 3.3%
Expected stock price volatility	25.69% - 27.25%
Risk free interest rate	6.03% - 6.71%
Expected life of options	10 years

During 1996, 106,150 options were granted. These options had a weighted average fair value of \$7.11 per option and a weighted average exercise price of \$21.13 per option.

The following table summarizes information about stock options outstanding at December 31, 1996.

Options Outstanding				Options Exercisable	
Range of Exercise Prices	Number Outstanding at 12/31/96	Wgtd. Avg. Remaining Contractual Life	Wgtd Avg. Exercise Price	Number Exercisable at 12/31/96	Wgtd. Avg. Exercise Price
\$15.31-\$18.625	230,625	6.9 years	\$16.98	167,250	\$17.11
\$19.00-\$21.75	255,650	8.6 years	\$20.90	75,875	\$20.89
\$28.50-\$30.00	64,715	3.8 years	\$29.89	64,715	\$29.89
\$15.31-\$30.00	550,990	7.3 years	\$20.32	307,840	\$20.73

(5) Stock repurchase plan

In March, 1995, the Company began a stock repurchase plan under which the Company was authorized to spend up to \$2.1 million for purchases of its common stock. During 1996, an additional \$4.0 million was authorized for the purchase of common stock. The Company repurchased 218,015 shares at an aggregate cost of approximately \$4.4 million in 1996 and 20,108 shares at an aggregate cost of \$.4 million in 1995. Repurchased shares are added to treasury stock and are available for general corporate purposes including the funding of the Company's employee stock option plan.

(6) Capital 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 shareholders. The Plan, which was renewed on May 31, 1996, provides for the possible issuance of a dividend of one common stock purchase right for each outstanding share of common stock. Under certain conditions, each right may be exercised to pur-

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

chase one share of common stock at an exercise price of \$75, 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 expires on May 31, 2006, and may be redeemed by the Company at any time prior to the occurrence of certain events at \$.05 per right.

The Company is authorized to issue 2.0 million shares of preferred stock, the terms and conditions to be determined by the Board of Directors in creating any particular series.

(7) Retirement benefits

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 funded by 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. Plan investment assets are invested primarily in equity securities, United States government securities and cash equivalents.

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

(Thousands of dollars)	1996	1995	1994
Components of pension income:			
Service cost	\$ 2,304	\$ 1,780	\$ 2,092
Interest cost	6,539	5,698	5,334
Actual return on plan assets	(13,660)	(27,424)	97
Net (amortization) and deferral	1,284	16,795	(11,151)
Net pension income	\$ (3,533)	\$ (3,151)	\$ (3,628)
Plan assets at fair value	\$137,039	\$128,361	\$105,902
Actuarial present value of projected benefit obligations:			
Accumulated benefit obligations			
Vested	(76,447)	(72,644)	(56,406)
Nonvested	(9,496)	(9,164)	(5,358)
Provision for future salary increases	(7,802)	(7,703)	(8,259)
Plan assets over projected benefit obligations	43,294	38,850	35,879
Unrecognized transition gain	(10,830)	(11,756)	(12,683)
Other unrecognized gain	(6,369)	(4,393)	(3,161)
Unrecognized prior service credits	(1,626)	(1,765)	(2,251)
Net prepaid pension costs	\$ 24,469	\$ 20,936	\$ 17,784
Major assumptions at year end:			
Discount rate	7.50%	7.50%	8.25%
Rate of assumed increase in compensation levels	5%	5%	5%
Expected long-term rate of return on plan assets	9%	9%	9%

The Company also has defined contribution retirement plans covering substantially all of its employees. During the year, the Company makes contributions of 75% of employee contributions, up to a maximum of 6% of employee earnings. All obligations of the Company are funded through December 31, 1996. The Company's expense for these plans totaled \$1,610,000, \$1,560,000 and \$1,444,000 in 1996, 1995 and 1994, respectively.

The Company sponsors two defined benefit post retirement plans that cover both salaried and hourly employees. One plan provides medical benefits, and the other plan provides life insurance benefits. Both plans are

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Lufkin Industries, Inc. and Subsidiaries

contributory, with retiree contributions adjusted periodically. Under SFAS No. 106 "Employers' Accounting for Post-retirement Benefits Other than Pensions," the Company accrues the estimated costs of the plans over the employee's service periods.

The following table sets forth the plans' combined funded status December 31, 1996, 1995 and 1994:

(Thousands of dollars)	1996	1995	1994
Accumulated post retirement benefit obligation:			
Retirees	\$ 7,213	\$ 7,701	\$ 9,208
Fully eligible active plan participants	1,357	951	883
Other active plan participants not yet eligible	2,554	2,133	1,932
Total accumulated post retirement benefit obligation	11,124	10,785	12,023
Unrecognized net actuarial gain (loss)	1,068	1,250	(180)
Accrued post retirement benefit cost	\$12,192	\$12,035	\$11,843
Net periodic cost of post retirement benefit:			
Service cost	\$ 156	\$ 135	\$ 168
Interest cost	801	923	882
Net periodic post retirement benefit cost	\$ 957	\$ 1,058	\$ 1,050

The Company's post retirement health care plan is unfunded. For measurement purposes, the submitted claims medical trend was assumed to be 10% in 1996, and 9.25% in 1997. Thereafter, the Company's obligation is fixed at the amount of the Company's contribution for 1997. A one percentage point increase in each year's healthcare costs trend rate would increase the accumulated post retirement benefit obligations as of December 31, 1996 by approximately \$125,000 and the aggregate of the service and interest costs components of net periodic post retirement cost for the year ended December 31, 1996 by \$11,000. In determining the accumulated post retirement obligation, a weighted-average discount rate of 7.50% in 1996 was used.

(8) Business segment information

The Company manufactures, sells and services various types of oil field pumping units, power transmission products, foundry castings and trailers. Corporate expenses are allocated to industry segments primarily based upon outside revenues. The following is a summary of key business segment and product group information:

(Thousands of dollars)	1996	1995	1994
Sales:			
Machinery Division			
Oil field pumping units	\$ 49,952	\$ 46,449	\$ 40,938
Power transmission products	73,127	60,131	55,334
Foundry castings	32,487	31,792	30,165
Other	-	-	3,051
Trailer Division	70,408	110,537	87,785
Total sales	\$225,974	\$248,909	\$217,273
Sales by geographic region:			
United States	\$182,724	\$208,989	\$183,147
Europe	2,980	3,362	2,916
Canada	12,470	10,870	8,273
Latin America	16,326	16,411	14,765
Other	11,474	9,277	8,172
Total sales	\$225,974	\$248,909	\$217,273

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Lufkin Industries, Inc. and Subsidiaries

	1996	1995	1994
Operating income (loss):			
Machinery Division	\$ 9,993	\$ 2,257	\$ (9,382)
Trailer Division	4,286	8,229	6,317
Total operating income (loss)	\$ 14,279	\$ 10,486	\$ (3,065)
Assets:			
Machinery Division	\$ 96,574	\$ 90,866	\$ 83,155
Trailer Division	16,125	23,058	19,046
General Corporate	73,226	72,372	74,573
Total assets	\$185,925	\$186,296	\$ 176,774
Capital expenditures:			
Machinery Division	\$ 11,295	\$ 6,600	\$ 4,016
Trailer Division	634	835	356
General Corporate	428	211	866
Total capital expenditures	\$ 12,357	\$ 7,646	\$ 5,238
Depreciation:			
Machinery Division	\$ 5,622	\$ 5,621	\$ 6,345
Trailer Division	848	878	930
General Corporate	480	551	620
Total depreciation	\$ 6,950	\$ 7,050	\$ 7,895

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

Lufkin Industries, Inc. and Subsidiaries

To the Shareholders 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, 1996 and 1995, and the related consolidated statements of earnings, shareholders' equity and cash flows for each of the three years in the period ended December 31, 1996. 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, 1996 and 1995, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1996, in conformity with generally accepted accounting principles.

ARTHUR ANDERSEN LLP

Houston, Texas
February 18, 1997

1996

B O A R D O F D I R E C T O R S



Front row (left to right)

F. B. Stevenson, Retired Chairman of the Board and Chief Executive Officer

W. W. Trout, Jr., Retired Vice President

M. K. Kurth, Jr., Manager of his own investments

**H. J. Trout, Jr., Manager of his own investments*

**T. W. Wiener, Attorney*

Back row (left to right)

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

B. H. O'Neal, President, Stewart & Stevenson

H. H. King, President, Henry H. King & Associates

**D. V. Smith, President and Chief Executive Officer*

L. R. Jalenak, Jr., Retired Chairman of the Board, Cleo, Inc.

W. T. Little, Management consultant

* Member Executive Committee

O F F I C E R S

D. V. Smith, President and Chief Executive Officer

J. H. Barber, Vice President

J. F. Finney, Vice President

J. F. Glick, Vice President

J. R. Partridge, Vice President

M. A. Penn, Vice President

E. G. Pittman, Vice President

S. H. Semlinger, Vice President

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

R. E. Myers, Jr., Assistant Secretary

R. D. Leslie, Assistant Treasurer



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