LUFKIN

LUFKIN INDUSTRIES, INC. 1998 ANNUAL REPORT

CORPORATE PROFILE

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.

NOTICE OF ANNUAL MEETING

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 5, 1999, at 9:00 a.m. local time.

FINANCIAL HIGHLIGHTS

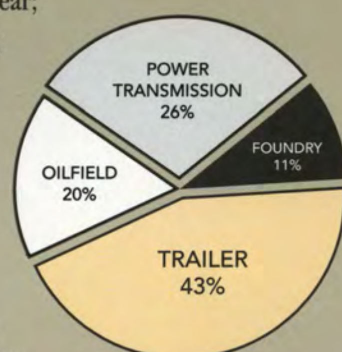
(Thousands of dollars, except per share amounts)	December 31, 1998	1997
Sales	**$283,705**	$287,562
Operating expenses	**263,332**	266,543
Earnings before income taxes	**21,627**	22,844
Net earnings	**13,626**	14,849
Earnings per share:		
Basic earnings per share	**$2.11**	$2.26
Diluted earnings per share	**$2.08**	$2.22
Dividends per share	**.72**	.68
Total assets	**242,795**	209,752
Working capital	**60,978**	68,854
Long term notes payable	**11,528**	6,665
Shareholders' equity	**162,896**	155,305

DOUGLAS V. SMITH
President and Chief Executive Officer

LETTER TO SHAREHOLDERS:

During the past year, the management team of Lufkin Industries continued to drive each of our four business units forward, better positioning them for long-term profitable growth. Our strategy has focused on achieving long-term growth through synergistic acquisitions, entering new markets, developing additional products and expanding the array of services Lufkin provides its customers. While 1998 started on an upbeat note, the slow down in world economies and the decline in the price of oil through the year caused our final overall financial results to be below our early expectations. We currently expect these trends to continue during the first half of 1999, yet we remain convinced that our strategies are appropriate and the successful execution of them will allow Lufkin to more effectively compete in world markets and achieve future growth.

For the year ended December 31, 1998, net sales were $283.7 million compared with $287.6 million for the year ended December 31, 1997. Sales in 1998 of oil field products decreased to $57.5 million compared with $81.6 million in 1997 primarily as a result of the low price of oil for much of the year; foundry casting products sales decreased to $30.3 million from $34.5 million a year ago; and power transmission products sales increased to $72.9 million compared with $70.8 million in 1997. Sales of trailers in 1998 were $123.0 million, up from $100.7 million in 1997. Contributing to the increase was the growing acceptance by customers of new types of trailers introduced over the last few years.

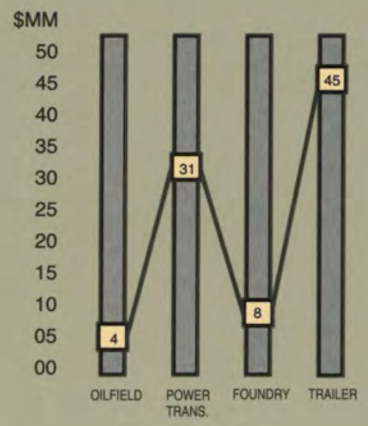


SALES BY DIVISION

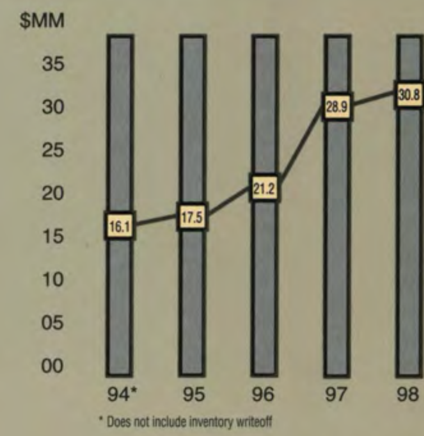
1998
$284 MM

Net operating income for the year ended December 31, 1998, was $21.1 million compared with $21.6 million in 1997. Net income for the year was $13.6 million compared with $14.8 million, and earnings per share (diluted) were $2.08 compared with $2.22 a year ago. Results for 1998 include non-recurring gains of approximately $1.4 million, or $0.21 per share (diluted) related to the sale of certain assets and lower than expected costs on certain employee benefits and manufacturing items. The 1998 results primarily reflect the lower sales volumes and change in product mix which offset improvements in our operations that increased productivity and lowered costs.

Lufkin's total backlog as of December 31, 1998, decreased to $87.9 million compared with $130.3 million a year ago. The backlog for oil field products was $3.7 million compared with $15.2 million a year ago reflecting the lower price of oil in 1998 compared with a year ago. At year-end the backlog for power transmission products was $31.1 million compared with $36.6 million primarily related to weakness in the Asian markets. For trailers, the backlog at December 31, 1998, was $44.7 million compared with $62.8 million. The decrease was due to recent record shipments of highway trailer products. The backlog for foundry castings was $8.4 million at December 31, 1998, compared with $15.7 million a year ago. The decline is attributable to increased pricing pressure and the depressed economies in the Far East markets. We continue to aggressively manage the cost side of our businesses and believe our backlogs will increase as the major industrial sectors in the world show improvement.



1998 DIVISION BACKLOG



EBITDA

Lufkin ended 1998 with total assets of $242.8 million and working capital of $61.0 million. Lufkin's stockholders' equity at year-end was $162.9 million; the book value was $24.77, an increase of 7% from $23.17 per share at December 31, 1997. Earnings before interest, taxes, depreciation and amortization (EBITDA), a traditional financial measure that continued to trend upward increasing to $30.3 million in 1998. EBITDA has increased in each of the last five years. The Company's current ratio was better than 2.5 to 1, with cash and temporary investments totaling $7.8 million. Lufkin's total debt at December 31, 1998, was $22.7 million. Lufkin continues to maintain a very sound financial position.

Having undergone an extensive review of each of its business units in 1997 and 1998, we have focused on ways to use resources to enhance shareholder value. We have done so by improving operational capability and performance, decreasing product cycle times, reducing scrap and work-in-process, introducing new and innovative products, developing new support for markets we currently serve, expanding our international sales presence, making new capital investments, increasing our customer support, providing the tools and training for our employees to increase productivity, and completing synergistic acquisitions.

During 1998, Lufkin completed three acquisitions. The first occurred in May of 1998 when we acquired Lone Star Machine Shop, Inc. of Denver City, Texas. Lone Star Machine Shop provides a variety of oil field services including the manufacturing of parts for pumping units. This acquisition expands Lufkin's capability to provide local manufacturing and to deliver on-site installation and necessary technical support to the oil field industry. We believe Lone Star Machine Shop provides unique opportunities to extend the role of Lufkin in serving the oil and gas industries.

The second acquisition completed in 1998 was the French company COMELOR located in Fougerolles, France. COMELOR manufactures industrial gears which are used in applications including those in the steel, material handling, power generation and petrochemical industries. The acquisition furthers our commitment to expanding this international presence of Lufkin's power transmission business. COMELOR provides an excellent platform to better support customers in Europe, the Middle East and Asia while providing an entry into several complementary markets which we are not currently serving.

Our third acquisition was completed in December when Lufkin acquired Delta-X Corporation, of Houston, Texas. Delta-X is a well-known supplier of oil well automation technology and will be integrated into our NABLA operation to form a stronger presence in the oil well automation market. This acquisition furthers our commitment to improving our position in the oil field automation markets.

These three acquisitions provide new products and technical services, additional sales support, greater manufacturing capabilities and open new markets for Lufkin. We intend to be aggressive in looking for similar types of acquisitions which will also be a good use of our financial resources and will provide greater benefit to our shareholders.

As part of the Board of Directors' view toward maximizing the long-term value of Lufkin, the Board has continued to believe that periodic repurchases of common stock of Lufkin represents an attractive use of a portion of available cash. In 1998, the Board authorized the use of up to $8.0 million for the repurchase of shares of Lufkin's common stock. A total of 198,000 shares of common stock, or 3% of the total shares outstanding, were purchased in 1998 pursuant to this repurchase authorization. As of December 31, 1998, a total of 490,000 shares have been repurchased under the Company's previous share repurchase programs.

In February 1998, the Board approved a 6% increase in the Company's quarterly cash dividend to $0.18 per share from the previous quarterly rate of $0.17 per share. The current rate is equivalent to an annual dividend of $0.72 per share. Lufkin has paid a quarterly cash dividend for 59 consecutive years. The combination of an aggressive stock repurchase program and an increasing dividend is part of management's strategy to have shareholders directly participate in the increase in the long-term value of Lufkin.

Much has been written about the potential problems associated with the Year 2000 date change. In response to the Y2K concerns, Lufkin has developed a comprehensive compliance program that addresses the necessary equipment and software upgrades to its systems and has substantially completed the testing phase of its plan. We anticipate that all of our computer systems will be Y2K compliant well in advance of the end of this year and the risks of the Y2K issue will be addressed.

We are not satisfied with the financial results in 1998. However, the longer term strategic direction of Lufkin was strengthened, and we firmly believe the direction is sound. We intend to capitalize on opportunities to improve our competitive position and increase market share. At the same time, we will deal effectively with any challenge that may arise.

I personally want to extend my appreciation to our employees, suppliers, customers and shareholders for their continued support and understanding. I can assure you that the management team and Board of Directors are dedicated to the long-term goal of increasing shareholder value.

Sincerely,

Douglas V. Smith

Douglas V. Smith
President and Chief Executive Officer.

POWER TRANSMISSION PRODUCTS

As a leading manufacturer of power transmission equipment, Lufkin's products are used in a diversified variety of industrial applications worldwide, including petrochemical, power generation, steel, marine and rubber. The Company's precision-made gears range in weights from 300 pounds to 250 tons, in power levels from 20 to 85,000 horsepower and in size up to 16 feet in diameter. They are primarily parallel shaft, enclosed gear drives precision-designed to meet all performance requirements. Lufkin's ongoing support and service is an important part of new equipment sales as well as in the after-market for installed power transmission equipment.

TRAILERS

Lufkin produces many different sizes and styles of vans; platforms; and high capacity, light-weight dump trailers. The Company's trailers are known for their quality construction, reliability, innovation of design, and competitive price. New products introduced in the last few years have expanded the market for the Company's trailers and provided additional growth opportunities.

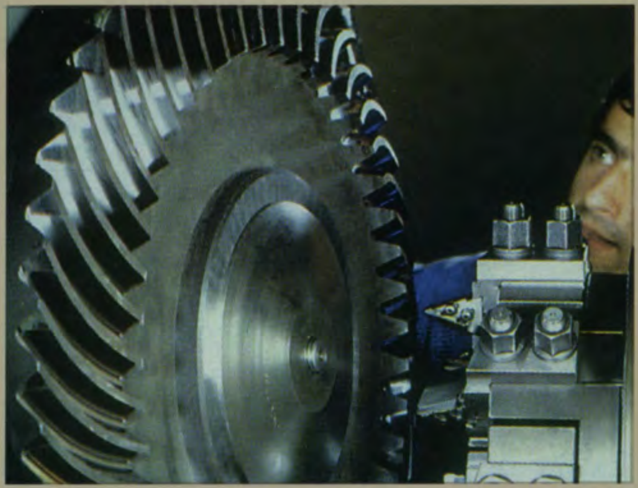
OIL FIELD EQUIPMENT AND SERVICE

Lufkin is one of the major suppliers worldwide of oil field equipment using some form of artificial lift. The Company's primary products include the conventional Mark II, Mobile, Low Profile and Air Balance beam-pumping units, which are extremely adaptable to meet customers' various production demands. In addition to Lufkin's high quality products, the Company provides a broad array of services including on-site installation, technical support and automation technology services. The Company maintains a significant presence in all major oil markets.

FOUNDRY PRODUCTS

Lufkin's foundry products include low-to-medium-volume ductile and gray iron castings used as components for numerous of the Company's products as well as original equipment manufacturers. The Company maintains a diversified customer base which includes manufacturers in such industrial sectors as construction equipment, material handling equipment, machine tools, valve and water works, pump and compressor, and automotive and truck.

In 1998, Lufkin continued to build upon its leadership position as a gear supplier to the power generation, petrochemical, oil and gas transmission, pumps, steel and marine industries. Lufkin's reputation for quality and status as a "world-class manufacturer" has enabled the Company to build its power transmission business even in difficult economic times.



The long-term factors affecting demand for gears are positive. While Lufkin experienced a slowdown in power transmission in 1998, the need for investment in new plants in developing countries as well as the updating of existing refineries and petrochemical plants to improve efficiency and address environmental requirements is ongoing.

Lufkin's power transmission products and services are well positioned to compete as economic conditions improve worldwide. The strategy for the future is to increase penetration in the Far East, Europe and Latin America markets by increasing sales efforts, forming strategic alliances with local manufacturers and, when appropriate, through acquisitions. Custom product development, which has produced many new applications and improved operational effeciency, will continue to be Lufkin's strategy to support its customers' requirement for better gear technology. Lufkin will selectively target those sectors that offer the most attractive returns.

OIL FIELD PRODUCTS

Lufkin's oil field products are divided into three areas: capital good, which are mainly new pumping units; service, which involves the repair and maintenance of existing oil field equipment; and automation, the computer control and analysis of artificial lift wells. Of the three areas, the effect of lower oil prices in 1998 had the greatest impact on capital good. Lufkin's shipments of new pumping units to the Canadian, South American and U.S. markets experienced an overall decline while Lufkin gained market share in the Middle East and Far East markets.

Lufkin has concentrated its recent efforts in oil field products on expanding the service and automation areas to offset part of the cyclical nature associated with capital goods. Lufkin's service consists of repair and maintenance business located primarily in the United States. This market has the most promising outlook and is where Lufkin can leverage its many strengths.

The automation services Lufkin provides basically target ways to use equipment to replace labor personnel. The recent acquisitions of Nabla and Delta-X have significantly expanded the services Lufkin provides and strengthened its leadership position in the domestic markets. Lufkin's strategy is to further leverage its strong brand name awareness and to expand its already broad array of products and services.

Foundry product sales in 1998 were below the record level achieved in 1997 due primarily to the lower demand for oil field products and commercial castings products. The foundry product division continues to focus on moving its product mix to higher value-added engineered castings and furthering its leadership position in the counterweight markets. Continued support of the existing customer base is vital to this effort.

The foundry's customer base has expanded and includes a wide range of customers from those in the industrial sector such as building construction equipment, material handling equipment, machine tools, valve and water works, pump and compressor, to special wear resistant parts.

During 1998 new facilites were added to provide increased capacity for large castings. The strategic direction for the future is to leverage the foundry's strong relationships with customers in growth markets for large, engineered castings while increasing efforts to provide unsurpassed customer service after the initial sale. This combination provides a sound basis for growth in the future.

Overall economic conditions were generally favorable in Lufkin's primary markets for trailers for most of 1998. The longer-term strategic direction for the trailer division is to grow market share by: increasing the penetration within the distribution channels; expanding the customer base; and reaching more users and dealers. Lufkin's manufacturing capacity and reputation for quality construction, reliability, innovation of design and competitive prices have positioned Lufkin for growth.

Lufkin continues to add to its diverse product offering by providing customers with new types of trailers. The open top chip van and double wall trailer are two examples of recent new product introductions. The many different needs of customers for varying sizes and styles of vans, platforms, and high capacity and lightweight dump trailers provides Lufkin with opportunity for growth. Lufkin's strategy is to selectively expand into new market niches where the opportunity is the greatest.

The fundamental trends of the trailer business are sound. An increasing average age of trailer fleets, a growth in outsourcing of transportation needs, the fact that trailers are being used more as short-term storage, and a long-term need for trucks to transport goods are all having a favorable impact on demand. Lufkin continues to focus on improving productivity and seeking opportunities to increase market share as part of our long-term strategy to achieve future growth in the trailer business.

Financial review

Financial Review and Quarterly Data

Common Stock Information

	1998			1997		
	Stock Price			Stock Price		
Quarter	High	Low	Dividend	High	Low	Dividend
First	**$35.938**	**$28.500**	**$.18**	$26.125	$21.500	$.17
Second	**38.063**	**29.250**	**.18**	26.625	21.500	.17
Third	**35.000**	**22.750**	**.18**	31.625	25.500	.17
Fourth	**26.500**	**16.875**	**.18**	40.500	30.750	.17

The Company's common stock is traded on the Nasdaq Stock Market (National Market) under the symbol LUFK and as of March 8, 1999, there were approximately 720 record holders of its common stock.

The Company has paid cash dividends for 59 consecutive years. Total dividend payments were $4,752,000 and $4,460,000 in 1998 and 1997, respectively.

Quarterly Financial Data (Unaudited)

In millions, except per share data	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
1998				
Net sales	**$73.6**	**$80.0**	**$66.7**	**$63.4**
Gross margin	**13.3**	**14.0**	**13.1**	**8.2**
Net earnings	**4.4**	**4.8**	**4.0**	**0.4**
Basic earnings per share	**.67**	**.73**	**.61**	**.06**
Diluted earnings per share	**.66**	**.72**	**.60**	**.06**
1997				
Net sales	$60.0	$68.7	$78.8	$79.9
Gross margin	8.1	12.1	13.8	15.0
Net earnings	1.5	3.9	4.6	4.8
Basic earnings per share	.23	.59	.70	.74
Diluted earnings per share	.23	.59	.69	.72

Additional Financial Information

Shareholders may obtain additional information for the year ended December 31, 1998, 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.

Management's Discussion and Analysis

Results of operations

Net sales for 1998 were $283.7 million compared to $287.6 million for 1997. Net sales for 1996 were $226.0 million. The Company reported net operating income of $21.1 million for 1998 and $21.6 million and $14.3 million for 1997 and 1996, respectively. For 1998, the Company reported net earnings of $13.6 million compared to $14.8 million and $10.5 million for 1997 and 1996, respectively.

During 1998, the Company experienced a decline in oil field and foundry casting revenues while the revenues in the power transmission products and trailer groups increased. The annual percentage increases (decreases) in revenues for the Company's product groups for the three years ended December 31, 1998 were as follows:

	Annual increases (decreases) in revenues		
	1998	1997	1996
Oil field pumping units	**(29)%**	63%	8%
Power transmission products	**3**	(3)	22
Foundry castings	**(12)**	6	2
Trailers	**22**	43	(36)
Total	**(1)%**	27%	(9)%

The sales mix of the Company's products for the three years ended December 31, 1998 was as follows:

	Percent of total sales		
	1998	1997	1996
Oil field pumping units	**20%**	28%	22%
Power transmission products	**26**	25	32
Foundry castings	**11**	12	15
Trailers	**43**	35	31
Total	**100%**	100%	100%

Oil field revenues decreased 29% to $57.5 million in 1998 from $81.6 million in 1997. Oil field revenues for 1996 were $50.0 million. During 1998, the Company experienced a decrease in demand for oil field products. This decline was due in general to a lower price per barrel of oil and the softening of the oil market world wide. The Company booked new orders of $46.0 million for 1998, compared to $85.0 million and $54.0 million in 1997 and 1996, respectively. The decreased bookings are also a result of the softening oil field market. The Company ended 1998 with a backlog for oil field products of $3.7 million as compared to $15.2 million at December 31, 1997. The backlog at December 31, 1996 was $12.1 million.

Sales of power transmission products increased 3% to $72.9 million from $70.8 million in 1997. Power transmission revenues were $73.1 million in 1996. Contributing to this increase were revenues of $3.3 million generated by the recent acquisition of COMELOR, a French company manufacturing industrial gear products. The 1998 bookings for power transmission products were $64.0 million, which decreased from $77.3 million in 1997. Bookings were $67.2 million in 1996. The decline in bookings and backlog is due to the general softening of the Asian markets. The 1998 backlog decreased to $31.1 million as compared to the 1997 backlog of $36.6 million. The 1996 year end backlog was $30.1 million.

Foundry castings revenues in 1998 decreased 12% to $30.3 million from $34.5 million in 1997. Sales of foundry castings were $32.5 million in 1996. The decline in revenues is primarily due to decreased sales of domestically produced machine tool components. New orders booked for foundry castings totaled $23.0 million in 1998. Bookings were $34.9 million and $34.0

million in 1997 and 1996, respectively. The decline in bookings and backlog is primarily due to greater pricing pressure from the Far East markets due to the depressed Asian economies combined with unfavorable changes in the monetary exchange rates. The Company ended 1998 with a backlog for foundry products of $8.4 million. The year end backlog for foundry products was $15.7 million and $15.3 million for 1997 and 1996, respectively.

During 1998, the Company experienced increased demand for its trailer products. Net revenues for 1998 increased 22% to $123.0 million from $100.7 million for 1997. Revenues from trailer products were $70.4 million for 1996. The year on year increases of $22.3 million in 1998 and $30.3 million in 1997, indicated growth in demand for highway trailers over the last three years. The 1998 backlog for trailer products declined to $44.7 million from $62.8 million at year end 1997. The backlog for trailer products was $40.1 million in 1996. The decline in backlog is due primarily to record levels of shipment activity in the first half of 1998. Management expected a decline in bookings in the second half of 1998 and took appropriate cost cutting actions, including adjusting workforce levels in the last quarter of 1998 and the first quarter of 1999 as business dictated. The demand for trailer products is expected to rise in the first half of 1999.

Gross profit margins remained stable at 17% for 1998 and 1997, up from 16% in 1996. This is indicative of the cost management strategies the Company has utilized in 1998, including the adjustment of workforce levels, as well as certain non-recurring items discussed below, which compensated for the decline in the oil market worldwide.

Selling, General and Administrative expenses (S.G. & A.) were $28.2 million and 10% of revenues for 1998, increasing slightly from 1997 when S. G. & A. expenses were $27.9 million and 10% of revenues. S. G. & A. expenses were $23.2 million and 10% of revenues for 1996. Year-on-year increases of $0.7 million and $4.0 million for 1998 and 1997, respectively, are in part due to costs associated with new acquisitions.

Net operating income for 1998 was $21.1 million, down 2% from $21.6 million in 1997 and up 48% from $14.3 million in 1996. The acquisition of the French company, COMELOR, is expected to be accretive to net earnings in 1999. This relative stability in 1998 and 1997 is a result of a favorable upturn in the trailer market and aggressive cost management in the midst of a declining world oil market as well as certain non-recurring items discussed below. Net earnings were increased by $1.4 million or $0.22 for basic earnings per share and $0.21 for diluted earnings per share resulting from non recurring gains related primarily to the sale of certain assets and lower than expect costs on certain employee benefits and manufacturing items. The Company plans to continue to proactively match production with activity while focusing on long term growth through synergistic acquisitions, exploring new markets and developing additional products.

Other income increased $0.1 million to $0.7 in 1998 compared to $0.6 million in 1997. Other income for 1996 was $0.4 million. Investment income decreased $0.2 million to $1.3 in million 1998 as compared to $1.5 million in 1997. For the 1998 and 1997 fiscal years, investment income has declined from $1.9 million in 1996 due to a decrease in temporary investment balances caused by the use of temporary investments for acquisition activities. Interest expense has increased $0.4 million to $0.7 million in 1998 from $0.3 million in 1997. The increase is primarily due to the use of cash and long term debt issued in relation to the Company's acquisition activities.

Net earnings for 1998 decreased 8% to $13.6 million or $2.11 for basic earnings per share and $2.08 for diluted earnings per share compared to $14.8 million in 1997 or $2.26 for basic earnings per share and $2.22 for diluted earnings per share. Net earnings for 1996 was $10.5 million or $1.57 for basic earnings per share and $1.56 for diluted earnings per share.

Liquidity and capital resources

At December 31, 1998, the Company had net working capital of $61.0 million compared to $68.9 million in 1997. During 1998, the Company generated $11.4 million net cash from operations compared to $10.9 million and $19.1 million for 1997 and 1996, respectively. Accounts receivable decreased $1.5 million to $38.9 million, down 4% over the 1997 balance of $40.4 million. The decrease in receivables is in part due to the reduced volumes of sales in the oil field and foundry areas, as a result of the weakened oil market and the depressed Far East markets. At December 31, 1998, inventories were $48.3 million compared to $30.1 million at year end 1997. This increase in inventories is due to the capitalization of certain maintenance and supply items and current year acquisition activities. At year end 1998, accrued liabilities were $17.0 compared to $14.0 million at year end 1997. The $3.0 million increase consisted primarily of increased payroll and benefits, warranty accruals and commissions payable. Dividends of $.72 per share totaling $4.8 million were paid during 1998 compared to $4.5 million and $4.0 million paid in 1997 and 1996 respectively. In 1998, the Company paid $19.8 million for additions to Property, Plant and Equipment (P. P. & E.) for capacity expansions and equipment replacements. P. P. & E. expenditures for 1997 and 1996 totaled $17.6 million and $12.4 million, respectively.

During 1998, the Company completed the acquisition of three different companies, for a total purchase price of $14.0 million in cash and common stock. These acquisitions were accounted for under the purchase method. Related to these acquisitions, the Company recorded Goodwill, representing the excess of purchase price over the fair value of the acquired net assets, of $2.1 million which will be amortized over a period of forty years. Treasury stock purchases during 1998 increased to $5.6 million, up from $.5 million in 1997. Treasury stock purchases in 1996 were $4.4 million. Under the Company's current stock purchase program authorizations of approximately $3.2 million remained at December 31, 1998 for future treasury stock purchases.

Net cash provided by financing activities was $5.8 million compared to a net use of cash in 1997 of $4.1 million. Cash used in financing activities in 1996 was $8.4 million. The increase in 1998 is due mainly to the Company's increased borrowings to finance acquisition activities. In June 1998 the Company entered into a credit agreement for a discretionary line of credit totaling $10.0 million. This agreement was superseded by an agreement in December 1998 increasing the discretionary line of credit to $13.0 million. At December 31, 1998, $3.5 million remained available. In recent years, P. P. & E. expenditures have been financed with internally generated funds. The Company plans to fund future P. P. & E. expenditures and its acquisitions program using these two methods. The Company believes that its existing working capital and available borrowings will be sufficient to satisfy 1999 cash requirements.

Market risk

The Company does not utilize financial instruments for trading purposes and holds no derivative financial instruments which could expose the Company to significant market risk. The Company's exposure to market risk for changes in interest rates relates primarily to its obligation under the discretionary line of credit, of which $9.5 million had been borrowed as of December 31, 1998. The weighted average interest rate of the $9.5 million of outstanding indebtedness was 6.0% at December 31, 1998.

Impact of the Year 2000

Year 2000 Issue. Many software applications, hardware and equipment and embedded chip systems identify dates using only the last two digits of the year. These products may be unable to distinguish between dates in the year 2000 and the dates in the year 1900. That inability, if not addressed, could cause applications, equipment or systems to fail or provide incorrect information after December 31, 1999, or when using dates after December 31, 1999. This in turn could have an adverse effect on the Company due to the Company's direct dependence on its own applications, equipment and systems and indirect dependence on those of other entities with which the Company must interact.

Compliance Program and Company Readiness. During 1997, the Company completed a comprehensive evaluation of its information technology systems to determine which systems would be affected by the year 2000 ("Y2K"). Following this evaluation, the Company determined that the purchase of new Y2K compliant software applications would provide increased commercial and financial functionality when compared to its existing mature software. The new information technology system is substantially complete and should be completely finished by the third quarter of 1999.

The Company is currently assessing the Y2K readiness of its non-information technology systems. This process is substantially complete and has involved the testing and evaluation of electrical equipment, embedded microprocessor chips and machine controls throughout the Company.

The Company has begun the process of requesting information about Y2K readiness from its vendors. This process is about 40% complete. The Company believes that the risk of sole-source exposure is minimal since alternate sources exist for most of the items purchased by the Company. Utility and communication providers and financial institutions have been contacted. They have responded that they are actively addressing the Y2K issue and feel that the risk of any interruption of service will be minimal.

The Company is receiving Y2K compliance questionnaires from its customers daily, indicating their awareness of the Y2K issue and its possible risks; thus the Company has chosen not to pursue the Y2K compliance of its customer base.

Costs to Address Year 2000 Compliance Issues. It has been estimated that the capitalizable costs of the new information technology software and its implementation will be approximately $9.3 million. The Company has capitalized such costs of $9.3 million and $4.3 million at December 31, 1998 and 1997, respectively. The new information technology system will be depreciated over a seven year useful life. The Company estimates that it will have to dispose of non-Y2K compliant computer equipment with a net book value of approximately $0.1 million. The non-information technology systems found to be non-compliant were immaterial in nature and of minimal cost to repair or replace.

Risk of Non-Compliance and Contingency Plans. The Company recognizes the possibility that its systems may not be completely Y2K compliant by December 31, 1999. There is also a risk that all third parties upon whom the Company relies will not be completely Y2K compliant at year end 1999. The effects of any degree of Y2K non-compliance on revenues, costs and net earnings is not possible to predict at this time.

Worst case scenarios include a total shutdown of all operations and a loss of all revenues in fiscal year 2000; however, the Company believes that the risk of this worst case scenario is almost non-existent. Although no assurance can be given, the Company believes that business interruption will be minimal and should not result in a material adverse effect on the Company's consolidated statement of earnings.

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.

Consolidated Balance Sheet

December 31, 1998 and 1997 (Thousands of dollars, except share and per share data)

Assets	**1998**	1997
Current assets:		
Cash	**$ 1,617**	$ 796
Temporary investments	**6,147**	17,521
Receivables, net	**38,904**	40,444
Income taxes receivable	**3,566**	–
Inventories	**48,344**	30,078
Deferred income taxes	**2,616**	1,911
Total current assets	**101,194**	90,750
Property, plant and equipment, net	**95,159**	75,478
Prepaid pension costs	**31,614**	27,689
Goodwill	**8,148**	8,391
Other assets	**6,680**	7,444
Total assets	**$242,795**	$209,752

Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	**$ 12,017**	$ 7,169
Short term debt	**8,500**	–
Current portion of long term notes payable	**2,687**	742
Accrued liabilities:		
Payroll and benefits	**6,687**	5,430
Accrued warranty expenses	**2,213**	1,150
Taxes payable	**2,561**	5,071
Commissions and other	**5,551**	2,334
Total current liabilities	**40,216**	21,896
Deferred income taxes	**16,774**	13,588
Post retirement benefits	**11,381**	12,298
Long term notes payable, net of current portion	**11,528**	6,665
Shareholders' equity:		
Common stock, par $1 per share; 20,000,000 shares authorized; 6,892,381 and 6,792,381 shares issued	**6,892**	6,792
Capital in excess of par	**18,080**	15,381
Retained earnings	**147,413**	138,539
Treasury stock, 315,330 shares and 199,399 shares, at cost	**(8,014)**	(4,244)
Accumulated other comprehensive income		
Cumulative translation adjustment	**(1,475)**	(1,163)
Total shareholders' equity	**162,896**	155,305
Total liabilities and shareholders' equity	**$242,795**	$209,752

See notes to consolidated financial statements.

Consolidated Statement of Earnings

Years ended December 31, 1998, 1997 and 1996 (Thousands of dollars, except per share data)

	1998	1997	1996
Net sales	**$283,705**	$287,562	$225,974
Cost of sales	**235,129**	238,657	188,877
Gross profit	**48,576**	48,905	37,097
Selling, general and administrative expenses	**28,203**	27,886	23,163
Other income, net	**(677)**	(553)	(374)
Operating income	**21,050**	21,572	14,308
Investment income	**1,307**	1,531	1,928
Interest expense, net	**(730)**	(259)	(29)
Earnings before income taxes	**21,627**	22,844	16,207
Provision for income taxes	**8,001**	7,995	5,756
Net earnings	**$ 13,626**	$ 14,849	$ 10,451
Net earnings per share:			
Basic	**$ 2.11**	$ 2.26	$ 1.57
Diluted	**$ 2.08**	$ 2.22	$ 1.56

See notes to consolidated financial statements.

Consolidated Statement of Shareholders' Equity

Years ended December 31, 1998, 1997 and 1996 (Thousands of dollars, except share and per share data)

	Common Stock Shares	Common Stock Amount	Capital In Excess of Par	Retained Earnings	Treasury Stock	Cumulative Translation Adjustment	Comprehensive Income
Balance, December 31, 1995	6,792,381	$6,792	$15,367	$121,692	$ (311)	$ (948)	
Comprehensive income							
Net earnings				10,451			$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)	
Comprehensive income							
Net earnings				14,849			14,849
Other comprehensive income, net of tax							
Foreign currency translation adjustment						(215)	(215)
Comprehensive income							14,634
Cash dividends, $.68 per share				(4,460)			
Purchases of treasury stock (20,383 shares)					(532)		
Exercise of stock options (54,982 shares)			14		1,042		
Balance, December 31, 1997	6,792,381	6,792	15,381	138,539	(4,244)	(1,163)	
Comprehensive income							
Net earnings				13,626			13,626
Other comprehensive income, net of tax							
Foreign currency translation adjustment						(312)	(312)
Comprehensive income							$13,314
Common stock issued for acquisitions	100,000	100	2,170				
Cash dividends, $.72 per share				(4,752)			
Purchases of treasury stock (199,726 shares)					(5,554)		
Exercise of stock options (83,795 shares)			529		1,784		
Balance, December 31, 1998	6,892,381	$6,892	$18,080	$147,413	$(8,014)	$(1,475)	

See notes to consolidated financial statements.

Consolidated Statement of Cash Flows

Years ended December 31, 1998, 1997 and 1996 (Thousands of dollars)

	1998	1997	1996
Cash flows from operating activities:			
Net earnings	**$13,626**	$14,849	$ 10,451
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation and amortization	**9,213**	7,888	6,950
Deferred income tax provision	**2,481**	3,332	3,699
Pension income	**(3,925)**	(3,220)	(3,533)
Post retirement benefits	**(917)**	106	157
(Gain) loss on sales of property, plant and equipment	**(199)**	136	(45)
Increase (decrease) in cash flow from changes in assets and liabilities excluding effects of acquisitions:			
Receivables, net	**5,504**	(5,696)	2,732
Income taxes receivable	**(3,566)**		
Inventories	**(10,843)**	(8,253)	3,174
Accounts payable	**2,237**	(414)	(4,395)
Accrued liabilities	**(2,256)**	2,140	(126)
Net cash provided by operating activities	**11,355**	10,868	19,064
Cash flows from investing activities:			
Additions to property, plant and equipment	**(19,830)**	(17,637)	(12,357)
Acquisitions of other companies, net of cash acquired	**(9,979)**	(2,761)	–
Proceeds from disposition of property, plant and equipment	**604**	1, 253	282
(Increase) decrease in other assets	**1,843**	22	(1,004)
Net cash used in investing activities	**(27,362)**	(19,123)	(13,079)
Cash flows from financing activities:			
Proceeds from short term debt, net of repayments	**14,500**	–	–
Payments of long term notes payable	**(742)**	(143)	–
Dividends paid	**(4,752)**	(4,460)	(3,993)
Proceeds from exercise of stock options	**2,314**	1,056	2
Purchase of treasury stock	**(5,554)**	(532)	(4,445)
Net cash provided by (used in) financing activities	**5,766**	(4,079)	(8,436)
Effect of translation on cash and temporary investments	**(312)**	(215)	–
Net decrease in cash and temporary investments	**(10,553)**	(12,549)	(2,451)
Cash and temporary investments, at beginning of year	**18,317**	30,866	33,317
Cash and temporary investments, at end of year	**$7,764**	$18,317	$30,866

See notes to consolidated financial statements.

Notes to Consolidated Financial Statements

One

Summary of significant accounting policies

Principles of consolidation:
The consolidated financial statements include the accounts of Lufkin Industries, Inc. and subsidiaries (collectively, 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 government 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)	1998	1997
Accounts receivable	**$38,772**	$37,034
Notes receivable	**732**	4,010
	39,504	41,044
Allowance for doubtful accounts	**(600)**	(600)
Net receivables	**$38,904**	$40,444

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. In July 1998, the Company began capitalizing certain maintenance and supplies inventories to better match the estimated cost of such inventories with the related equipment produced. Such inventories were capitalized and will be amortized over the three years of their estimated use and had the effect of increasing net earnings by $800,000 or $0.13 for both basic and diluted earnings per share in 1998.

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 (P. P. & E.) balances and useful lives:

(Thousands of dollars)	(in Years)	1998	1997
Land	-	**$ 2,592**	$ 2,297
Land improvements	10-25	**6,056**	5,960
Buildings	12.5-40	**58,678**	55,687
Machinery and equipment	3-12.5	**160,266**	166,602
Furniture and fixtures	5-12.5	**5,268**	5,711
Computer equipment	3-7	**20,138**	14,470
Total property, plant and equipment		**252,998**	250,727
Less accumulated depreciation		**(157,839)**	(175,249)
Total property, plant and equipment, net		**$ 95,159**	$ 75,478

Notes to Consolidated Financial Statements (continued)

Summary of significant accounting policies (continued)

Management continually evaluates whether events or circumstances have occurred that indicate the remaining estimated useful life of long-lived assets (including P. P. & E., goodwill, covenants not to compete and other intangible assets) may warrant revision or that remaining balances may not be recoverable.

Intangible assets:
The cost over fair value of net tangible assets of acquired businesses ("Goodwill") is amortized on a straight line method over forty years. Management periodically evaluates recorded goodwill balances, net of accumulated amortization, for impairment based on the undiscounted cash flows associated with the asset compared to the carrying amount of that asset. Management believes that there have been no events or circumstances which warrant revision to the remaining useful life or affect the recoverability of goodwill in any of its business units. Other intangible assets, which include covenants not to compete, are amortized on the straight line method over their estimated lives. Amortization expense related to Goodwill and other intangible assets was $290,000, $184,000 and $0 in 1998, 1997 and 1996, respectively.

New accounting pronouncements:
In March 1998, the AICPA issued Statement of Position (SOP) 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." The SOP provides guidance with respect to accounting for the various types of costs incurred for computer software developed or obtained for the Company's use. The Company intends to adopt SOP 98-1 in the first quarter of 1999 and believes that adoption will not have a significant effect on its consolidated financial statements.

In April 1998, the AICPA issued SOP 98-5, "Reporting on the Costs of Start-Up Activities." At adoption, SOP 98-5 requires the Company to write off any unamortized start-up costs as a cumulative change in accounting principle and expense all future start-up costs as they are incurred. The Company intends to adopt SOP 98-5 in the first quarter of 1999 and believes that adoption will not have a significant effect on its consolidated financial statements.

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 basic and diluted earnings per share for 1998, 1997 and 1996 is illustrated below:

(Thousands of dollars, except share and per share data)	**1998**	1997	1996
Numerator:			
Numerator for basic and diluted earnings per share–income available to common shareholders	**$ 13,626**	$ 14,849	$ 10,451
Denominator:			
Denominator for basic earnings per share–weighted-average shares	**6,464,680**	6,558,536	6,659,751
Effect of dilutive securities: Employee stock options	**100,080**	131,423	55,061
Denominator for diluted earnings per share–adjusted weighted-average shares and assumed conversions	**6,564,760**	6,689,959	6,714,812
Basic earnings per share	**$2.11**	$2.26	$1.57
Diluted earnings per share	**$2.08**	$2.22	$1.56

Income taxes:
The Company follows Statement of Financial Accounting Standards (SFAS) No. 109 "Accounting for Income Taxes." Under SFAS No. 109, deferred income 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.

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

Two

Income Taxes

Net deferred income tax assets and liabilities are comprised of the following:

(Thousands of dollars)	1998	1997
Current deferred income tax assets		
Gross assets	**$ 2,616**	$ 2,663
Gross liabilities	**–**	(752)
Total, net	**2,616**	1,911
Noncurrent deferred income tax liabilities		
Gross assets	**7,382**	6,999
Gross liabilities	**(24,156)**	(20,587)
Total, net	**(16,774)**	(13,588)
Net deferred income tax liabilities	**$(14,158)**	$ (11,677)

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

(Thousands of dollars)	1998	1997
Inventories	**$ 859**	$ (10)
Prepaid pension costs	**(11,065)**	(9,691)
Payroll and benefits	**1,264**	1,144
Accrued warranty expenses	**275**	404
Post retirement benefits	**3,984**	4,304
Capital loss and tax credit carryforwards	**136**	157
Depreciation	**(9,373)**	(8,152)
Other, net	**(238)**	167
Net deferred income tax liabilities	**$(14,158)**	$ (11,677)

The income tax provision for 1998, 1997, and 1996 consisted of the following:

(Thousands of dollars)	1998	1997	1996
Current	**$5,520**	$ 4,663	$ 2,057
Deferred	**2,481**	3,332	3,699
Total	**$8,001**	$ 7,995	$ 5,756

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

(Thousands of dollars)	1998	1997	1996
Tax provision computed at statutory rate	**$7,570**	$ 7,995	$ 5,672
Tax effect of:			
Expenses for which no benefit was realized	**206**	166	362
Tax-exempt interest and dividend income exclusion	**–**	(11)	(158)
Other, net	**225**	(155)	(120)
Provision for income taxes	**$8,001**	$ 7,995	$ 5,756

Cash payments for income taxes totaled $9,615,000, $3,075,000 and $2,178,000 for 1998, 1997 and 1996, respectively.

For income tax reporting purposes at December 31, 1998, the Company has foreign tax credit carryforwards of $125,000 and $11,000, which expire December 31, 1999 and 2000, respectively.

Notes to Consolidated Financial Statements (continued)

Three

Inventories

Inventories used in determining cost of sales were as follows:

(Thousands of dollars)	1998	1997
Finished goods	**$ 5,331**	$ 5,122
Work in process	**14,805**	6,381
Raw materials	**28,208**	18,575
Total	**$48,344**	$30,078

Inventories accounted for on a LIFO basis were $32,394,000 and $26,339,000 and on a FIFO basis were $15,950,000 and $3,739,000 at December 31, 1998 and 1997, respectively. Had the FIFO method been used in determining all inventory values, inventories would have been $18,656,000 and $17,071,000 higher at December 31, 1998 and 1997, respectively. Net income was increased by approximately $400,000 ($.06 per share for both basic and diluted earnings per share) for 1996 as a result of using the LIFO method as compared to the FIFO method of accounting for certain inventories.

Four

Business combinations

All acquisitions have been accounted for under the purchase method. Goodwill if any, resulting from each acquisition is being amortized over a forty year life. The results of these companies' operations are included in the Company's Consolidated Statement of Earnings from their respective acquisition dates forward. The accompanying balance sheet as of December 31, 1998 includes estimated allocations of the respective purchase prices which may be subject to later adjustment.

The acquisitions of Fannie Lee Mitchell Company and the Nabla Corporation, both oil field service companies, were completed in July 1997. The Company paid $2,761,000 in cash, net of cash acquired and issued $7,550,000 of long term notes payable in conjunction with these acquisitions. Allocations of the purchase price included goodwill of approximately $5,500,000.

In April 1998, the Company completed the acquisition of the assets of Lone Star Machine Shop, another oil field service company, for a cash purchase price of $2,3000,000. Goodwill was $1,080,000.

In November 1998, the Company completed the acquisition of the French company COMELOR, a manufacturer of industrial gears, for a purchase price of $7,615,000 in cash and 100,000 shares of common stock. The fair value of the net assets acquired exceeded the purchase price, therefore net assets were recorded based on the purchase price.

In December 1998, the Company completed the acquisition of the Delta-X Corporation, a software and hardware manufacturer for the oil field service industry. Total cash payments were $4,087,000 and goodwill was $977,000.

The following unaudited pro forma information presents the results of the Company's consolidated results of operations had the acquisitions taken place on the first day of the year being reported:

	Year Ended December 31,	
(Thousands of dollars, except per share amounts)	**1998 (Unaudited)**	1997 (Unaudited)
Pro forma revenues	**$300,409**	$316,128
Pro forma net earnings	**14,375**	16,232
Pro forma earnings per common share:		
Basic	**$2.22**	$2.47
Diluted	**$2.19**	$2.43

These pro forma results are presented for information purposes only and do not purport to show the actual results which would have occurred had the business combinations been consummated on the first day of the year being reported, nor should they be viewed as indicative of future results of operations.

Notes to Consolidated Financial Statements (continued)

Five

Debt obligations

The Company's short term debt obligations at December 31, 1998 and 1997 consist of the following:

(Thousands of dollars)	1998	1997
Discretionary line of credit with a domestic bank, payable daily, floating interest rate agreed to by Company and bank, currently 6.0%, unsecured	$9,500	–
Less-Discretionary line of credit, classified as long term notes payable and current portion of long term notes payable, discussed below	(6,000)	–
Note payable to domestic bank, due January 4, 1999, interest at 6.87%, unsecured	5,000	–
	$8,500	–

Subsequent to December 31, 1998 and prior to the issuance of these financial statements, the Company refinanced $6,000,000 of the discretionary line of credit into a long term obligation, with interest equal to the current Euro currency rate plus 1.75% per annum, payable in sixteen quarterly installments of $375,000 plus interest beginning on the last business day of March, 1999 and maturing on the last business day of December, 2002, and is unsecured. As a result, $4,500,000 was classified as long term notes payable as of December 31, 1998 and $1,500,000 was classified as the current portion of long term notes payable.

The Company's long term notes payable at December 31, 1998 and 1997 consist of the following:

(Thousands of dollars, except payment amounts)	1998	1997
Notes payable to individuals, interest ranging from 6.50% to 6.65%, due in quarterly installments ranging from $9,000 to $55,000 with balloon payments at maturity ranging from $996,000 to $2,162,000 maturing August 2000 to July 2002, unsecured	$ 6,332	$ 6,907
Notes payable to individuals, stated interest rate of 0% with an imputed interest rate of 6.50%, due in annual installments totaling $167,000, maturing August 2000, unsecured	333	500
Notes payable to bank, floating interest rate, based on TIOP quarterly, currently 3.75%, due in quarterly installments ranging from $50,000 to $123,000 secured by certain assets	1,550	–
Discretionary line of credit, subsequently refinanced as long term notes payable, discussed above	6,000	–
Less-current maturities of long term notes payable	(2,687)	(742)
Total	$11,528	$6,665

Notes to Consolidated Financial Statements (continued)

Debt obligations (continued)

Under the terms of certain notes payable, cash and temporary investments in the amount of $5,850,000 is restricted for the payment of these notes.

Related party notes payable including in long term notes payable at December 31, 1998 and 1997 consist of the following:

(Thousands of dollars)	1998	1997
Note payable to current employee, interest at 6.50% with principal and interest payable quarterly	**$ 315**	$ 495
Note payable to current employee, stated interest rate 0% with an imputed interest rate of 6.50%, with principal and interest payable annually	**167**	250
Less current maturities of long term, related party notes payable	**(263)**	(263)
Total	**$ 219**	$ 482

Principal payments of long term notes payable as of December 31, 1998 are as follows:

(Thousands of dollars)	
Year ending December 31,	
1999	$ 2,687
2000	2,624
2001	1,932
2002	6,850
2003	81
2004	41
Total	$14,215

Cash payments for interest related to long term notes payable totaled $347,000, $125,000 and $0 in 1998, 1997 and 1996, respectively.

Six

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 common 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 date of grant. Outstanding options may be canceled and reissued under terms specified in the plan.

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

	1998	1997	1996
Options outstanding, beginning of year	**606,766**	550,990	447,965
Granted (per share)			
1996 ($18.125 to $21.75)			106,150
1997 ($21.625 to $39.875)		121,583	
1998 ($21.750 to $31.875)	**154,726**		
Exercised (per share)			
1996 ($15.875)			(125)
1997 ($15.31 to $30.00)		(54,982)	
1998 ($15.875 to $30.00)	**(83,795)**		
Forfeited (per share)			
1996 ($15.875 to $20.00)			(3,000)
1997 ($15.875 to $22.75)		(10,825)	
1998 ($15.875 to $38.00)	**(11,937)**		
Options outstanding, end of year	**665,760**	606,766	550,990

Notes to Consolidated Financial Statements (continued)

Employee stock option plan (continued)

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 accounted for consistent with SFAS Statement No. 123, "Accounting for Stock-Based Compensation," the Company's net earnings and earnings per share would have been reduced to the following pro forma amounts, (in thousands except per share data):

		1998	1997	1996
Net earnings	As reported	**$13,626**	$14,849	$10,451
	Pro forma	**$13,085**	$14,569	$10,316
Basic earnings per share	As reported	**$2.11**	$2.26	$1.57
	Pro forma	**$2.02**	$2.22	$1.55
Diluted earnings per share	As reported	**$2.08**	$2.22	$1.56
	Pro forma	**$1.99**	$2.18	$1.54

The effects of applying SFAS No. 123 to the pro forma disclosure amounts 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	2.23% - 3.51%
Expected stock price volatility	30.03% - 31.42%
Risk free interest rate	4.59% - 5.81%
Expected life of options	5 - 10 years

Options granted during 1998 had a weighted average fair value of $7.82 per option and a weighted average exercise price of $23.54 per option. At December 31, 1998, 94,686 options authorized remained available to be granted.

The following table summarizes information about stock options outstanding at December 31, 1998:

Options Outstanding				Options Exercisable	
Range of Exercise Prices	Number Outstanding at 12/31/98	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable at 12/31/98	Weighted Average Exercise Price
$15.31-$18.625	155,670	5.0 years	$17.08	147,670	$17.03
$19.00-$21.750	328,489	8.0 years	$21.24	129,438	$20.81
$27.50-$33.375	95,253	4.7 years	$30.12	69,507	$30.01
$38.00-$39.875	86,348	8.8 years	$38.05	21,587	$38.05
$15.31-$39.875	665,760	6.9 years	$23.72	368,202	$22.04

Notes to Consolidated Financial Statements (continued)

Seven

Stock repurchase plan

The Company began a stock repurchase plan under which the Company was authorized to spend up to $2,100,000 for purchases of its common stock. An additional $4,000,000 was authorized for the purchase of common stock and an additional $8,000,000 was authorized in 1998. The Company repurchased 199,726 shares at an aggregate cost of $5,600,000 in 1998 and 20,383 shares at an aggregate cost of $500,000 in 1997. 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. Authorizations of approximately $3,200,000 remained at December 31, 1998.

Eight

Capital stock

The Board of Directors adopted a "Shareholder Rights Plan" (the "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 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 purchase 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 expire 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 2,000,000 shares of preferred stock, the terms and conditions to be determined by the Board of Directors in creating any particular series.

Nine

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.

(Thousands of dollars)	**1998**	1997	1996
Change in projected benefit obligation:			
Projected benefit obligation, beginning of year	**$108,266**	$ 93,745	$ 89,510
Service cost	**3,391**	2,692	2,304
Interest cost	**7,430**	7,096	6,539
Amendments	**–**	2,602	–
Actuarial gain	**4,541**	7,400	374
Benefits paid	**(5,583)**	(5,269)	(4,982)
Projected benefit obligation, end of year	**$118,045**	$108,266	$ 93,745
Change in plan assets:			
Fair value of plan assets, beginning of year	**$156,421**	$137,039	$128,361
Actual return on plan assets	**28,588**	24,651	13,660
Benefits paid	**(5,583)**	(5,269)	(4,982)
Fair value of plan assets, end of year	**$179,426**	$156,421	$137,039
Funded status:			
Excess of fair value of plan assets over projected benefit obligation	**$ 61,380**	$ 48,155	$ 43,294
Unrecognized net actuarial gain	**(21,734)**	(11,523)	(6,369)
Unrecognized prior service cost	**945**	960	(1,626)
Unrecognized net transition asset	**(8,977)**	(9,903)	(10,830)
Prepaid pension costs	**$ 31,614**	$ 27,689	$ 24,469
Components of net periodic pension cost (income):			
Service cost	**$ 3,391**	$ 2,692	$ 2,304
Interest cost	**7,430**	7,096	6,539
Expected return on plan assets	**(13,796)**	(12,070)	(13,660)
Amortization of unrecognized (gain) loss	**(950)**	(938)	1,284
Net periodic pension cost (income)	**$ (3,925)**	$ (3,220)	$ (3,533)
Weighted-average assumptions at year end:			
Discount rate	**6.75%**	7.0%	7.5%
Expected return on plan assets	**9.0%**	9.0%	9.0%
Rate of compensation increase	**5.0%**	5.0%	5.0%

Notes to Consolidated Financial Statements (continued)

Retirement benefits (continued)

The Company also has defined contribution retirement plans covering substantially all of its employees. During the year, the Company made contributions of 75% of employee contributions up to a maximum employee contribution of 6% of employee earnings. Employees may contribute up to an additional 6% (in 1% increments) which is not subject to match by the Company. All obligations of the Company are funded through December 31, 1998. The Company's expense for these plans totaled $1,994,000, $1,747,000 and $1,610,000 in 1998, 1997 and 1996, 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 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 illustrates the change in benefit obligation, change in plan assets and funded status of the postretirement plans:

(Thousands of dollars)	**1998**	1997	1996
Accumulated postretirement benefit obligations:			
Retirees	**$ 7,295**	$ 7,048	$ 7,213
Fully eligible active plan participants	**1,646**	1,295	1,357
Other active plan participants not yet eligible	**3,522**	2,977	2,554
Total accumulated postretirement benefit obligations	**$ 12,464**	$ 11,320	$ 11,124
Change in accumulated postretirement benefit obligation:			
Accumulated postretirement benefit obligation, beginning of year	**$ 11,320**	$ 11,124	$ 10,785
Service cost	**247**	162	156
Interest cost	**817**	788	801
Participant contributions	**859**	839	797
Actuarial loss	**1,472**	965	183
Benefits paid	**(2,251)**	(2,558)	(1,598)
Accumulated postretirement benefit obligation, end of year	**$ 12,464**	$ 11,320	$ 11,124
Fair value of plan assets	**$ –**	$ –	$ –
Funded status:			
Excess of total accumulated post retirement benefit obligations over fair value of plan assets	**$ 12,464**	$ 11,320	$ 11,124
Unrecognized net actuarial (gain) loss	**(1,083)**	978	1,068
Accrued post retirement benefit cost	**$ 11,381**	$ 12,298	$ 12,192
Components of net periodic post retirement benefit costs:			
Service cost	**$ 247**	$ 162	$ 156
Interest cost	**817**	788	801
Net periodic postretirement benefits cost	**$ 1,064**	$ 950	$ 957
Weighted average assumptions at year end:			
Discount rate	**6.75%**	7.0%	7.5%

The Company's post retirement health care plan is unfunded. For measurement purposes, the submitted claims medical trend was assumed to be 9.25% in 1997 and 10% in 1996. Thereafter, the Company's obligation is fixed at the amount of the Company's contribution for 1997.

Notes to Consolidated Financial Statements (continued)

Ten

Business segment information

The Company operates with four business segments--oil field, power transmission, foundry and trailer. In keeping with the Company's strategic objective of vertical integration, the Company's foundry segment also provides its oil field and power transmission segments with commercial castings. The four operating segments are supported by a common corporate group. The accounting policies of the segments are the same as those described in the summary of significant accounting policies. Corporate expenses and assets are allocated to the operating segments primarily based upon third party revenues. The following is a summary of key business segment and product group information.

(Thousands of dollars)	1998	1997	1996
Sales:			
Oil field	**$ 57,523**	$ 81,571	$ 49,952
Power transmission	**72,882**	70,786	73,127
Foundry	**30,302**	34,512	32,487
Trailer	**122,998**	100,693	70,408
Total sales	**$283,705**	$287,562	$225,974
Sales by geographic region:			
United States	**$243,262**	$234,334	$182,724
Europe	**7,004**	3,714	2,980
Canada	**10,940**	19,012	12,470
Latin America	**11,045**	19,316	16,326
Other	**11,454**	11,186	11,474
Total sales	**$283,705**	$287,562	$225,974
Operating Income:			
Oil field	**$ 2,880**	$ 11,785	$ 5,557
Power transmission	**7,265**	1,012	3,815
Foundry	**1,123**	1,515	390
Trailer	**9,782**	7,260	4,546
Total operating income	**$ 21,050**	$ 21,572	$ 14,308
Assets:			
Oil field	**$ 51,318**	$ 46,902	$ 26,500
Power transmission	**70,950**	54,095	53,769
Foundry	**24,958**	19,062	16,274
Trailer	**31,108**	23,761	16,125
Corporate	**64,461**	65,932	73,257
Total assets	**$242,795**	$209,752	$185,925
Capital expenditures:			
Oil field	**$ 5,485**	$ 2,061	$ 5,114
Power transmission	**2,368**	4,514	2,468
Foundry	**4,657**	5,879	3,713
Trailer	**755**	703	634
Corporate	**5,214**	4,480	428
Total capital expenditures	**$ 18,479**	$ 17,637	$ 12,357
Depreciation/Amortization:			
Oil field	**$ 2,140**	$ 1,596	$ 1,109
Power transmission	**4,014**	3,845	3,449
Foundry	**1,213**	1,184	1,064
Trailer	**823**	820	848
Corporate	**1,023**	443	480
Total depreciation/amortization	**$ 9,213**	$ 7,888	$ 6,950

Report of Independent Public Accountants

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, 1998 and 1997, and the related consolidated statements of earnings, shareholders' equity and cash flows for each of the three years in the period ended December 31, 1998. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated 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 consolidated 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 consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Lufkin Industries, Inc., and subsidiaries as of December 31, 1998 and 1997, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 1998, in conformity with generally accepted accounting principles.

Arthur Andersen LLP

Houston, Texas
February 17, 1999

DIRECTORS & OFFICERS

DIRECTORS

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

L. R. Jalenak, Jr.
Manager of his own investments

*H. H. King
Manager of his own investments

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

W. T. Little
Management consultant

J. H. Lollar
Managing Partner,
Newgulf Exploration, L.P.

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

*D. V. Smith
President
Chief Executive Officer

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

W. W. Trout, Jr.
Retired Vice President

*T. E. Wiener
Attorney

* Member Executive Committee

OFFICERS

D. V. Smith
President
Chief Executive Officer

J. F. Glick
Vice President

C. J. Haley, Jr.
Secretary-Treasurer

L. M. Hoes
Vice President

M. A. Penn
Vice President

P. G. Perez
Vice President

E. G. Pittman
Vice President

S. H. Semlinger
Vice President

R. E. Myers, Jr.
Assistant Secretary

S. T. Coker
Assistant Secretary

R. D. Leslie
Assistant Treasurer

LUFKIN

LUFKIN INDUSTRIES, INC.
P.O. Box 849 Lufkin, Texas 75902-0849