Here Are 13.1 billion Reasons I Don’t Own Barrick Gold Corp.

Description

If you don’t like taking big risks with your investments, you’ll probably want to avoid companies with a lot of debt. After all, if a company owes a lot of money, and things don’t go its way, it will be under serious financial pressure (and its stock price would surely collapse). If you don’t believe me, just look at what’s going on in the energy sector, where the hardest-hit stock prices all come from companies with high-debt levels.

This brings me to the world’s largest gold miner, **Barrick Gold Corp.** (TSX:ABX)(NYSE:ABX). Thanks to years of aggressive growth, combined with botched execution, its debt stands at a mountainous US$13.1 billion.

So, just how serious is this debt level? Should it prevent you from buying the stock?

The good news

Barrick has some things working in its favour. First of all, its debt is almost entirely long term in nature; only 8% of scheduled repayments are due before 2018. Thus refinancing isn’t an issue for at least a couple of years. Second, Barrick’s debt is almost entirely fixed-rate. So, if the Federal Reserve raises interest rates later this year, then Barrick will be unaffected.

Finally, Barrick is acknowledging its own problem and trying to fix it. As stated in the company’s annual report, “As we return to our original values, no priority is more important than restoring a strong balance sheet.” To be more specific, Barrick hopes to reduce its debt load by at least US$3 billion in 2015.

The bad news

First, let’s look at the short term. Even though Barrick doesn’t have to repay much debt, interest costs total about US$800 million per year.

Let’s put that number in perspective. The company will mine about 6.4 billion ounces of gold this year at an average cost of US$880. Given a gold price of US$1,200, Barrick’s profit would total about $2 billion. After taking out some other expenses, that profit number is closer to US$1.5 billion. So, financing costs may very well consume more than half of total profits.

In the long term the outlook is even worse. Barrick must repay about US$1.7 billion of debt in 2018 and 2019, and also must invest billions of dollars just to maintain production. If gold prices are higher by then, the company should be okay. Otherwise, it could be in deep trouble.

What's the worst-case scenario?

Since 2011, gold prices have fallen from nearly US$1,900 per ounce to about US$1,200. Barrick can't afford to see the price go much lower.

To illustrate, look what happens if gold goes down to US$1,000. That US$1.5 billion profit number shrinks to about US$500 million, which isn't even enough to cover interest payments. Granted, Barrick does have US$2.7 billion in cash, but this could disappear quickly under the wrong circumstances.

So, if gold does go down, I wouldn't want to be a Barrick shareholder. Energy investors know exactly what I'm talking about.

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