After a 200% Rally, Is Barrick Gold Corp. Becoming Overvalued?

Description

Investors who'd bought **Barrick Gold Corp**. (TSX:ABX)(NYSE:ABX) back in October will have done well. In a period of about eight months, they would have realized an impressive 200% return on their initial investment, plus two dividend payments from Barrick.

While rallies like this create profits for investors holding the stock, they also create problems for both potential buyers who are looking to get in as well as for those who are holding. Those holding the stock are wondering whether or not to take profits after realizing such an impressive return, and those on the sidelines are wondering whether or not the stock still has more upside.

The answer to this question ultimately depends on a few factors. Namely the future price direction of gold, Barrick's valuation relative to its peer group (which will be determined by its fundamentals), and the overall valuation of the sector (which depends on pricing, macroeconomic factors, production growth prospects, and debt loads).

Based on these factors, there is good reason to believe that Barrick is not overvalued for investors looking to hold for a two- to three-year period, and while prices may see volatility during this time frame, they should end up higher over time.

Barrick looks favorable compared with its peers

Barrick has a fairly large peer group, but its most comparable peers are names like **Goldcorp Inc., Agnico Eagle Mines Ltd., Newmont Mining Corp., and Kinross Gold.** When comparing Barrick to these names on a price-to-cash flow basis (which excludes non-cash charges like depreciation), Barrick still looks affordable.

Using data from **Bank of Nova Scotia** (which sees gold prices at $1,250 per ounce in 2016 and $1,275 per ounce afterwards), Barrick is currently trading at a 2017 price-to-cash flow ratio of 7.9. This compares to its peer group average (which consists of the above mentioned names) of about nine. The highest-valued name in the peer group was Agnico at 13 times cash flow.

Why is Barrick being discounted to its peer group? One of the key reasons is Barrick's high debt levels and history of poor operational performance. At the end of 2014, Barrick had total debt of $13 billion and net debt of $10.5 billion, which had been accumulated as a result of Barrick making a poorly executed move into the copper space and botching the construction of a large gold mine in South America.

This huge debt burden was a concern for shareholders in a falling price environment, but now not only are gold prices rallying, but Barrick has also implemented a plan to reduce its total debt to a low $5 billion in the next few years, from that 2014 high of $13 billion.

Barrick has been successful, reducing its total debt to $10 billion at the end of 2015 with a goal to reduce debt in 2016 by $2 billion to $8 billion. Barrick has been successful so far this year, achieving 42% of this goal in the first quarter through strong free cash flow and asset sales. Barrick has a large cash balance of $2.3 billion and should see free cash flow of close to $1 billion in 2016 (a massive improvement from the -$1.1 billion in 2014), which should give it all the levers it needs to reduce its debt load.

As Barrick continues to reduce its debt load and gives a better outlook into long-term production, valuations compared with its peers should improve.

The gold mining sector as a whole could see increased valuations

Gold has received some good press lately. George Soros increased his gold exposure substantially (he bought shares of Barrick as well as a gold ETF). And **Morgan Stanley** anticipates $1,400 per ounce gold and stated that gold has entered a new and long bull market due to the large amount of negative interest rate policies globally and central banks may begin diversifying their holdings into gold as a result.

This could attract more investors to the gold sector. Barrick should benefit greatly from rising prices as it has a high sensitivity to gold prices; a $100 per ounce rise in gold prices would boost cash flow in 2016 by 14%. This sensitivity is higher than most its peers, which means Barrick should outperform in a rising gold environment, especially as it executes its plan to reduce its debt load and costs.

Even in a stable pricing environment, Barrick should see upside as it executes its transformation plan.

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