Barrick Gold Corporation ABX [TSE]

Morningstar Rating	Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat	Stewardship Grade	Industry	Sector
★★★★	33.67	51.00	33.20	76.50	High	None	—	Gold & Silver	Industrial Materials

Per share prices in CAD

Our Updated Take on Gold Prices

by Morningstar Analyst

Analysts covering this company do not own its stock.

Pricing data through October 07, 2008. Rating updated as of October 07, 2008.

Currency amounts expressed with "$" are in U.S. dollars (USD) unless otherwise denoted.

Analyst Note Oct. 07, 2008 | Vahid Fathi, D.Sc.

In our Sept. 12 take on gold prices, we pointed out that gold had met a low target of about $730 per ounce intraday in relation to the U.S. Dollar Index, which had recovered to 80. Subsequently, as the U.S. Dollar Index fell back to around 77, gold rallied to more than $800. The U.S. Dollar Index has jumped again since then, to more than 81, but gold is now at $857 at the time of this writing. We think this is very telling of the underlying strength of gold in the face of a stronger U.S. dollar.

More important, we think that gold has decoupled from the price of oil. In our opinion, this decoupling is crucial and signifies that bullion has significant room for further appreciation on its own as an asset class in times of financial crisis. Though there have been significant forced sales of gold to cover margin calls elsewhere in the financial markets, gold behavior and strength is very much noticeable. It is instructive to recall that during the last historical gold price peak in 1982, the average investor could not wait to sell physical gold, including the family jewels. This time around, not only is the mass selling of physical gold by the public absent, but demand--for gold coins, for example--has been so strong that there is a shortage.

We think gold could reach $1,250 in a year's time. However, our approach to investing in gold and establishing a hedge against inflation remains unchanged. First, we continue to believe that a small portion of one's portfolio should be in gold. Second, to manage risk--including company-specific, geopolitical, and currency-related risk--we think gold-related exchange-traded funds and mutual funds provide exposure not only to gold, but also to the benefits of diversification that individual stocks don't offer.

Though for now gold market participants are differentiating between physical and paper proxies for gold (including gold miners' shares) by favoring the former, we think that lower raw-material costs, including sharply lower energy costs, will finally begin to improve gold producers' margins and thus their leverage to the price of gold, which traditionally is the reason for investing in gold equities as opposed to the bullion itself.

With runaway raw-material and energy costs, this leverage had all but evaporated, leading to rather docile gold share performance relative to the price of gold. Put differently, we suggest that a case can be made that while base metal prices are collapsing in the current global recessionary environment and energy prices are significantly below their recent peaks, gold could shine as the metal of choice on the basis of its status as an asset class in the foreseeable financial environment. A prerequisite for this speculation on our part is the decoupling of gold and oil prices, which appears to have begun in earnest.

Thesis Jun. 17, 2008 | Vahid Fathi, D.Sc.

Barrick is the world's largest gold producer and has the most resource ounces. Nevertheless, like most other gold producers, exposure to volatile gold prices earns the company a spot in our high fair value uncertainty category. Given this and the no-moat nature of the industry in general, we would require a substantial discount to our estimated fair value before investing.

Gold diversifies a portfolio and serves as a hedge against inflation and the falling dollar. However, gold mining is a tough business. With no control over prices, gold producers have to control costs to generate profits consistently, which is easier said than done. Also, a gold miner needs to be geographically diversified to reduce operational and geopolitical risks. Finally, gold producers have to replenish depleted ounces to maintain a robust production profile.

Barrick scores well on most of these. It enjoys relatively favorable costs in the industry. Barrick has a geographically diversified portfolio of 27 operating mines,

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10 projects located across five continents, and large land positions on some of the world s best prospective exploration belts. After a few years of production declines, Barrick appears to be positioned to increase production on the back of its new mines and a plump project pipeline. Production in 2007 totaled 8.06 million ounces, which was below the 8.64 million ounces produced in 2006. Average price realizations shot up to $619 per ounce from $543 per ounce. Though average cash costs increased to $350 per ounce from $283 per ounce, the relative competitive position of the company did not materially change as all gold miners experienced significant input cost increases in their operations. Barrick continues to be one the most profitable mega gold producers. The company has come a long way from its humble beginning and still remains nimble enough to grow.

The company has also been successful in replenishing depleted ounces. Through in-house exploration as well as acquisitions, gold resources have increased from about 51 million ounces in 1996 to 125 million ounces at the end of 2007. Importantly, measured and indicated reserves were up 45% to more than 50 million ounces in 2007. Although the company has been reducing its corporate hedge book in recent years, there is a matter of some 9 million ounces of project-related hedges that still overhang the relative share price performance. The hedge book means that an investment in Barrick does not provide complete exposure to gold price movements, thus diluting the diversification benefit--a fact that has not gone unnoticed, judging by Barrick shares' historical relative underperformance. Although the company is to be commended for having completely eliminated its large corporate hedge commitments, more of the same on its project-specific hedging practice would go a long way toward further boosting the share price performance.

Another concern is Barrick's return on invested capital, which, despite decent profits and cash flows, has been paltry during the last few years, reflecting the economics of the industry. We expect return on invested capital to improve as the company increases production from the new lower-cost mines.

Valuation

We're maintaining our fair value estimate for Barrick at CAD 51 per share based on our assumed long-term average gold price in our capital budgeting model. It is worth noting that forward sales by Barrick have a negative impact on our fair value estimate of approximately CAD 5 per share. In the absence of any forward sales, our fair value estimate would be CAD 56 per share.

Because gold--and, by extension, gold stocks--provides diversification in a portfolio, we use a relatively low cost of capital for gold stocks: 5.5% in Barrick's case, which we use to discount Barrick's future cash flows. The price of gold, volume, and operating margin are key drivers of our fair value estimate. Market valuation of future gold ounces is likely to improve, should the company decide to pare its project-specific hedge book.

Risk

Unexpected production problems, opportunity costs involved with reducing the hedge book, or a big drop in gold prices could hurt Barrick's business. Environmental issues are also a perennial concern for the mining industry.

Bulls Say

- The hedging discount that has plagued Barrick shares appears to have disappeared to some extent, now that the firm has scrapped its hedging strategy.
- Barrick is not overly exposed to political or production risk in any one region because of its nice mix of

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geographically diverse mines.
- Gold companies tend to be countercyclical. They also provide an excellent hedge to inflation risk.

Bears Say
- For most investors, a far better option than a gold stock is a gold mutual fund or exchange-traded fund. These eliminate company-specific risk.
- Operating in a commodity industry fraught with high fixed costs and zero pricing power, Barrick has struggled to earn its cost of capital.
- In addition to not being fully exposed to gold price movements, Barrick's results are likely to be stunted by project-specific hedge book commitments.

Financial Overview
Growth: Recent externally and internally procured gold ounces have improved the firm's long-term growth prospects. The company's robust project pipeline should assure a healthy production profile in an increasingly difficult environment for the industry to replace reserve ounces year in and year out.

Profitability: Barrick has been one of the most profitable miners, but its returns on assets aren't much to write home about. The paltry returns, however, are common in this industry.

Financial Health: Barrick is in good financial health. Its operations throw off decent free cash flow. The company's balance sheet boasted more than $2 billion in cash at year end 2007.

Company Overview
Profile: Barrick Gold is the world's largest gold producer. It has operating mines and development projects on four continents and produced about 8.06 million ounces of gold in 2007 at a cash cost of $350 per ounce.

Strategy: Hedging had been Barrick's hallmark, distinguishing the company from its peers. Historically, when judged by its corporate hedge book, Barrick has been effectively bearish on gold. This was a winning strategy for Barrick during the bear market in gold. But, to a large extent, the entire industry's, including Barrick's, aggressive forward sales were also partly responsible for the much longer-than-expected duration of the bear market in gold. The firm has since adopted a no-hedge corporate policy, but the size of its project-specific hedge book means that complete exposure to gold price movements will not be achieved in the near future. Having aggressively hedged fuel and some raw-material inputs, the company is dodging some of the cost pressures affecting the mining industry, though cash costs were no less than $350 per ounce in 2007.

Management: Gregory Wilkins, a Barrick director since 1991, took over as CEO in February 2003. The company announced in March 2008 that Wilkins has taken a leave of absence because of illness. Chairman Peter Munk, a director of Barrick since 1984, has assumed the CEO responsibilities until further notice. Management scores well for having completely eliminated its corporate fixed-price hedge book in early 2007. Management's would even score higher if aggressive project-specific hedging were also discontinued.

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Analyst Notes

Oct. 07, 2008

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Sept. 12, 2008

Our Take on Gold Prices

When we last opined on the relationship between the U.S. dollar and the price of gold we suggested that the U.S. dollar index is likely to move up to around 80 and gold should move down to $730 per ounce. Little did we know that the realignment would happen with such speed. We

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Analyst Notes (continued)

saw gold hitting this low target during the day of Sept. 11, but as of the time of this writing gold had bounced sharply to $751. Of course, this does not suggest that the carnage in gold and gold producers' shares is over, especially if the U.S. dollar strengthens further than what we originally suggested. For now, though, it seems to us that gold is likely to consolidate and settle down in a trading range that is commensurate with a forecast of a higher trading range of 75 to 80 for the U.S. dollar index.

Our view on gold miners remains unchanged. Given the high to very high uncertainty of our fair value estimates, we continue to emphasize that individual gold miners' shares provide exposure not only to gold prices, but also to other uncertainties such as geopolitical risks, exchange-rate risks, and operational risks. Gold exchange-traded funds or gold mutual funds could provide more diversification.

Sept. 04, 2008

No Prisoners in Gold Industry

Relatively low-cost gold miners such as Lihir , Agnico-Eagle, Yamana, Barrick, and Kinross have seen their share prices pummeled alongside the rest of gold miners'. The market is taking no prisoners--we see a mass execution. Looking back over the past few decades, it is difficult to find a comparable period that can measure up to the ferocity of equity market carnage (relative to the decline in the price of gold).

A possible explanation is that gold miners' stocks had gotten too far ahead of gold prices on the ascent, but we don't think so. Another possible explanation is that gold miners' stocks are justifiably baking in expectations for a much more precipitous decline in gold prices. A third possibility is that since we saw a parabolic ascent to the moon for gold prices fueled by easy credit, we should expect a similar parabolic descent back to earth now that the easy credit has disappeared. Despite these uncertainties, what we do know is that the pricing side of the market has rarely been so misaligned relative to the physical side--demand for gold is currently quite robust, although it's hard to take comfort in such knowledge. Compounding the gold price decreases are industrywide cost increases, which have caused gold miners' margins to get squeezed.

Nonetheless, our view remains the same. A small position in precious metals as a hedge against inflation makes sense to us. Further, the current carnage in equity markets has presented some opportunities. However, we continue to emphasize that individual gold miners' shares provide exposure not only to gold prices, but also to other uncertainties such as geopolitical risks, exchange-rate risks, and operational risks. Gold exchange-traded funds or gold mutual funds could provide more diversification.

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Morningstar's Approach to Rating Stocks

Our Key Investing Concepts

- Economic Moat
- Discounted Cash Flow
- Discount Rate
- Fair Value
- Uncertainty
- Margin of Safety
- Consider Buying/Consider Selling
- Stewardship Grades

At Morningstar, we evaluate stocks as pieces of a business, not as pieces of paper. We think that purchasing shares of superior businesses at discounts to their intrinsic value and allowing them to compound their value over long periods of time is the surest way to create wealth in the stock market.

We rate stocks 1 through 5 stars, with 5 the best and 1 the worst. Our star rating is based on our analyst's estimate of how much a company's business is worth per share. Our analysts arrive at this "fair value estimate" by forecasting how much excess cash--or "free cash flow"--the firm will generate in the future, and then adjusting the total for timing and risk. Cash generated next year is worth more than cash generated several years down the road, and cash from a stable and consistently profitable business is worth more than cash from a cyclical or unsteady business.

Stocks trading at meaningful discounts to our fair value estimates will receive high star ratings. For high-quality businesses, we require a smaller discount than for mediocre ones, for a simple reason: We have more confidence in our cash-flow forecasts for strong companies, and thus in our value estimates. If a stock's market price is significantly above our fair value estimate, it will receive a low star rating, no matter how wonderful we think the business is. Even the best company is a bad deal if an investor overpays for its shares.

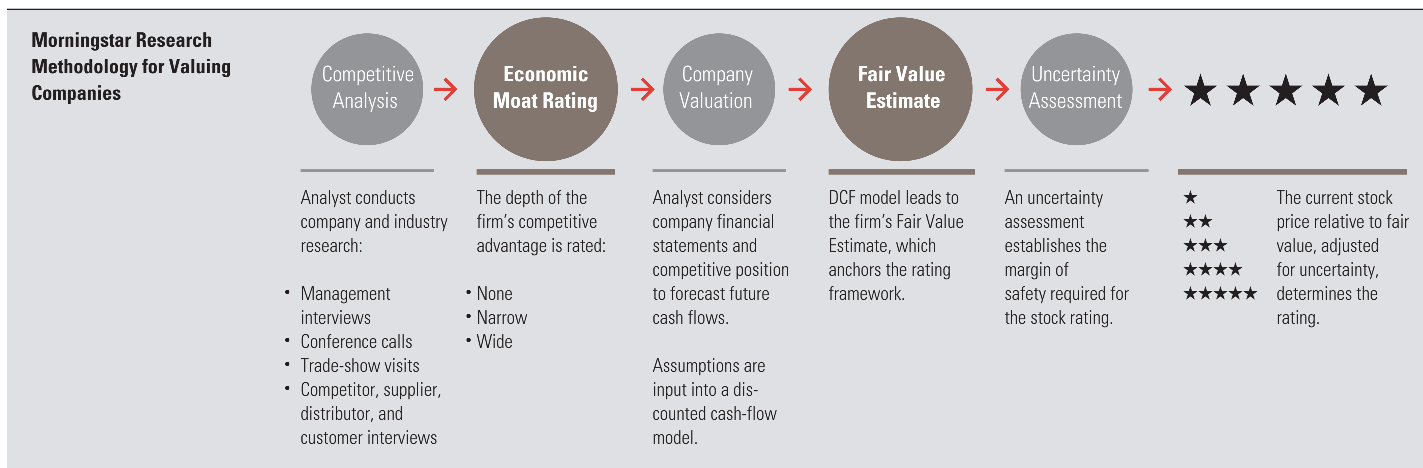
Our fair value estimates don't change very often, but market prices do. So, a stock may gain or lose stars based just on movement in the share price. If we think a stock's fair value is $50, and the shares decline to $40 without much change in the value of the business, the star rating will go up. Our estimate of what the business is worth hasn't changed, but the shares are more attractive as an investment at $40 than they were at $50.

Because we focus on the long-term value of businesses, rather than short-term movements in stock prices, at times we may appear out of step with the overall stock market. When stocks are high, relatively few will receive our highest rating of 5 stars. But when the market tumbles, many more will likely garner 5 stars. Although you might expect to see more 5-star stocks as the market rises, we find assets more attractive when they're cheap.

We calculate our star ratings nightly after the markets close, and issue them the following business day, which is why the rating date on our reports will always be the previous business day. We update the text of our reports as new information becomes available, usually about once or twice per quarter. That is why you'll see two dates on every Morningstar stock report. Of course, we monitor market events and all of our stocks every business day, so our ratings always reflect our analyst's current opinion.

Economic Moat

This is our assessment of a firm's ability to earn returns consistently above its cost of capital in the future, usually by virtue of some competitive advantage. Competition tends to drive down such economic profits, but companies



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that can earn them for an extended time by creating a competitive advantage possess an economic moat. We see these companies as superior investments.

We're big fans of companies that are low-cost producers, create high switching costs for their customers, or have strong brands or long-lasting patents, because all of these characteristics allow companies to protect their competitive position. For example, Tiffany is far more profitable than a run-of-the-mill jewelry chain because it has a strong brand that creates a moat around its business, allowing it to charge more than competitors.

Discounted Cash Flow

This is a method for valuing companies that involves projecting the amount of cash a business will generate in the future, subtracting the amount of cash that the company will need to reinvest in its business, and using the result to calculate the worth of the firm. We use this technique to value nearly all of the companies we cover.

Discount Rate

We use this number to adjust the value of our forecasted cash flows for the risk that they may not materialize. For a profitable company in a steady line of business, we'll use a lower discount rate, also known as "cost of capital," than for a firm in a cyclical business with fierce competition, since there's less risk clouding the firm's future.

Fair Value

This is the output of our discounted cash-flow valuation models, and is our per-share estimate of a company's intrinsic worth. We adjust our fair values for off-balance sheet liabilities or assets that a firm might have--for example, we deduct from a company's fair value if it has issued a lot of stock options or has an under-funded pension plan. Our fair value estimate differs from a "target price" in two ways. First, it's an estimate of what the business is worth, whereas a price target typically reflects what other investors may pay for the stock. Second, it's a long-term estimate, whereas price targets generally focus on the next two to 12 months.

Uncertainty

To generate the Morningstar Uncertainty Rating, analysts consider factors such as sales predictability, operating leverage, and financial leverage. Analysts then classify their ability to bound the fair value estimate for the stock into one of several uncertainty levels: Low, Medium, High, Very High, or Extreme. The greater the level of uncertainty, the greater the discount to fair value required before a stock can earn 5 stars, and the greater the premium to fair value before a stock earns a 1-star rating.

Margin of Safety

This is the discount to fair value we would require before recommending a stock. We think it's always prudent to buy stocks for less than they're worth.The margin of safety is like an insurance policy that protects investors from bad news or overly optimistic fair value estimates. We require larger margins of safety for less predictable stocks, and smaller margins of safety for more predictable stocks.

Consider Buying/Consider Selling

The consider buying price is the price at which a stock would be rated 5 stars, and thus the point at which we would consider the stock an extremely attractive purchase. Conversely, consider selling is the price at which a stock would have a 1 star rating, at which point we'd consider the stock overvalued, with low expected returns relative to its risk.

Stewardship Grades

We evaluate the commitment to shareholders demonstrated by each firm's board and management team by assessing transparency, shareholder friendliness, incentives, and ownership. We aim to identify firms that provide investors with insufficient or potentially misleading financial information, seek to limit the power of minority shareholders, allow management to abuse its position, or which have management incentives that are not aligned with the interests of long-term shareholders. The grades are assigned on an absolute scale--not relative to peers--and can be interpreted as follows: A means "Excellent," B means "Good," C means "Fair," D means "Poor," and F means "Very Poor."

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