5G Investment Upcycle in Global Telecoms

Telcos to Press on Despite Uncertainties, Raising Pressure on Credit Profiles
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“Higher-than-expected 5G investments and low visibility on investment returns will keep free cash flow constrained, reducing rating headroom over the next three years.”

Janice Chong, Fitch Ratings

5G deployments in 1H20 have progressed slowly in most parts of the world amid the coronavirus pandemic and the corresponding delays in spectrum auctions. However, Fitch Ratings expects rising pressure on the sector’s credit metrics, with higher 5G spending in 2021-2022 and the tough economic environment delaying economic returns.

Nearly half of the 90 publicly rated companies in our global telecom portfolio (excluding tower companies) have low rating headroom, underlining the importance of prudent capital management through staggered investments, dividend cuts, and non-core asset sales to preserve balance-sheet strength.

Diverging 5G Priorities
Diverging capex patterns have emerged during the pandemic, with 5G priorities advancing in South Korea, China, Taiwan, Singapore, Australia and the US. We expect the pandemic effects on 5G rollout to be short-lived, leading to a resumption of 5G-related investments in 2021.

5G adoption will advance unevenly across the Asia-Pacific (APAC) region. Europe and the Middle East are likely to ramp up 5G rollout in 2021-2022, followed by Latin America. The alternative of deprioritising 5G may put telcos at risk of falling behind rivals, as capex and spectrum spending are vital in preserving competitive capabilities in an increasingly commoditised sector.

Uncertainties to Fuel 5G Risk
Policy shifts to restrict the deployment of Chinese 5G equipment will raise investment and procurement uncertainties in markets heavily reliant on Huawei Technologies Co., Ltd. and ZTE Corporation.

5G has so far offered limited success in consumer segments, due to the lack of differentiation from existing 4G services and, therefore, the ability to charge premium pricing. Its potential lies in enterprise applications that can be fully realised through a costlier deployment of a 5G standalone network.

Stretched Leverage
We expect operating cash flow to lag significantly behind 5G investments, keeping free cash flow (FCF) constrained over the next three years. Our forecasts include staggered 5G capex and spectrum cost as these become certain, with low visibility on returns during the rating horizon. The impact will, however, be uneven across the portfolio, given the asymmetrical development.

5G will favour telcos with scale and strong balance sheets, which may contribute to diverging credit quality over time within the telecoms sector.

Related Research
UK Ban on Huawei’s 5G Equipment Increases Telecoms’ Capex (July 2020)
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Pandemic Influencing 5G Rollout

There were 23 operators deploying 5G services over January-July 2020, bringing total 5G commercial launches to 78 across 37 countries. However, 5G services in these countries are still limited, as pandemic-related disruptions led to the deferment of 2020, bringing total 5G commercial launches to 78 across 37 countries. Nevertheless, 5G services in these countries are still limited.

Leading the way are telcos from advanced markets, such as South Korea, China, Taiwan, Australia, Singapore and the US, which are pressing ahead with 5G plans to lead technology innovation. In the Middle East, the early adopters include Kuwait, Qatar and the UAE. The GSM Association (GSMA) predicts there will be 1.8 billion 5G connections by 2025, with developed Asia and North America leading the pack. It expects 5G to account for around 50% of total mobile connections in these regions, ahead of Europe (34%) and the 20% global average.

5G Adoption in 2025 (% of connections)

![5G Adoption in 2025](image)

Source: Fitch Ratings, GSMA

We envisage a resumption in 5G plans in 2021, although the economic fallout from the pandemic could curb consumer demand, including for the 5G-enabled iPhone by Apple, which is slated for launch towards the end of the year. GSMA sees greater pandemic effects in APAC – given its early adoption – but expects "a short-term dip rather than a long-term slump".

Telecom Capex/Revenue Across Regions

![Telecom Capex/Revenue Across Regions](image)

Source: Fitch Ratings

Fitch believes the telecoms sector in the US has modest flexibility to reduce capex, with wireless spending (including 5G) remaining a priority. Capex intensity in North America is the lowest globally, averaging 14% in 2017-2021F, highlighting market saturation. Conversely, a heavy capex burden in APAC – where emerging markets like India, Indonesia, Sri Lanka and the Philippines are already dealing with capex intensity of up to 30%-40% – mean operators are likely to pace 5G investments over the next few years to support cash flow. Likewise, Fitch expects telcos in Latin America to cut capex by as much as 30% and defer 5G trials to 2021 to mitigate cash burn, as the region is still transitioning to 4G.

A number of countries, including the UK, France, Spain, Portugal, Austria, Brazil, Mexico, Colombia and the Czech Republic, have postponed 5G spectrum auctions this year, and telcos have cut discretionary capex to focus on maintaining network resilience. This comes amid delays in the absence of solid business cases and restrictions on Chinese 5G telecoms equipment in some countries.

We also expect a delayed 5G rollout to 2021 in western Europe as operators prioritise 4G network upgrade and fibre-to-the-home (FTTH) investments. The European Union target for 2025 calls for every European household to have access to download speeds to 100Mbps on a connection that is upgradeable to 1Gbps. Spain is the most advanced in terms of FTTH deployment, while Italy, Germany and the UK lag.

The Cost of a Huawei Ban

Procurement Uncertainties

Outside of the US, restrictions on Chinese 5G equipment could delay 5G rollouts and place immense pressure on telcos that keep prices affordable, particularly in the emerging markets. According to GSMA, Huawei and ZTE had a combined market share of more than 40% of global radio access network (RAN) revenue in 2018, almost double the percentage in the US.

India has yet to announce an official ban on Chinese telecoms equipment. However, an escalating border dispute with China may lead to restrictions on the participation of Chinese equipment vendors, which could serve as reference for other markets in determining 5G cost implications and the success of open RAN architectures. Chinese vendors account for more than half of the Indian telecom equipment market, largely concentrated among Vodafone-Idea, Bharti Airtel Limited (BBB-/Negative) and state-owned BSNL. Reliance Jio is the only telco in India that does not use any Chinese equipment and is planning to develop its home-grown open RAN 5G solution. A 5G spectrum auction was originally planned to take place in early 2020, but has now been delayed to 2021.

In spite of this, many countries such as Spain, Hungary, Sweden, Ireland, Bahrain, the Philippines, Thailand and Malaysia are still reluctant to ban Chinese telecom equipment, highlighting diverging views on this issue.

Timeline of Huawei Ban Across Countries

![Timeline of Huawei Ban](image)

Source: Fitch Ratings
UK Mobile Network Operators' Exposure to Huawei Network Equipment

<table>
<thead>
<tr>
<th>Operator</th>
<th>Descriptions</th>
<th>Core</th>
<th>RAN</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vodafone</td>
<td>Vodafone Group Plc (BBB/Stable) estimates it will cost telcos up to GBP2 billion and the UK’s position in 5G. Huawei’s equipment accounted for 32% of its RAN sites.</td>
<td>Cisco</td>
<td>Ericsson, Huawei, Nokia</td>
</tr>
<tr>
<td>EE, BT</td>
<td>BT is likely to be the most affected by the ban, due to its heavy reliance on Huawei equipment for both its mobile network (under EE) and wholesale fixed-line network (Openreach). Huawei reportedly accounted for two-thirds of EE’s 4G network. The ban would cost BT more than the GBP500 million it had quoted under the previous 35% cap.</td>
<td>Ericsson, Huawei</td>
<td>Huawei, Nokia</td>
</tr>
<tr>
<td>Three UK</td>
<td>CK Hutchison Group Telecom Holdings Limited’s (BBB+/Stable) UK operations did not provide any cost estimates, but a ban could delay 5G rollout up to 18 months. The telco’s exposure is limited to Huawei’s 5G RAN, as it uses Nokia 5G core – placing it in a better position than domestic peers that use Huawei’s 5G core network. Three is now switching to its alternative vendor for 5G RAN, Ericsson.</td>
<td>Nokia</td>
<td>Ericsson, Samsung, Ericsson, Huawei</td>
</tr>
<tr>
<td>O2</td>
<td>O2 has the smallest direct exposure to Huawei equipment, although it has a network-sharing agreement with Vodafone.</td>
<td>Ericsson</td>
<td>Ericsson, Nokia</td>
</tr>
</tbody>
</table>

Source: Fitch Ratings, www.lightreading.com, companies

Costly Swap Out

The phase-out of Huawei 5G equipment in the UK raises concerns over inter-operability of different vendor equipment, which may prompt a replacement of existing 4G infrastructure. This could cost carriers up to GBP2 billion and a “two to three years” delay in 5G rollout, according to the government. The UK government ruling in June 2020 requires removal of all 5G Huawei equipment from the telco networks by 2027. It has also banned new Huawei 5G equipment from end-2020, reversing its earlier decision to cap the vendor’s RAN at 35%.

GSMA, in its April 2019 report, estimated that a full ban on Chinese vendors from the 5G network rollout in Europe would cost operators EUR55 billion and at least an 18-month delay of 5G launches. However, Telefonaktiebolaget LM Ericsson (BBB-/Stable) and Nokia Corporation (BBB-/Stable) claimed such estimates were overstated. Another report by Strand Consult suggests a much lower price tag of USD3.5 billion for Europe to replace equipment purchased from Huawei and ZTE in 2016–2019, reversing its earlier decision to cap the vendor’s RAN at 35%.

5G equipment based on the open industry standard, open RAN, could be an alternative for operators as they seek to control capex. Rakuten and US operator Dish Network led the deployment of 5G open RAN by turning to smaller vendors for their 5G rollouts.

5G Returns Still Years Off

Lack of Premium Pricing in Consumer Market

Our forecast assumes flattish growth in 5G markets, in the absence of meaningful 5G-supported revenue streams such as ‘internet-of-things’ (IoT) or enterprise 5G services. At its infancy, 5G still lacks compelling applications that sufficiently differentiate its value from LTE services. This inhibits telcos’ ability to price their services at a premium. There is also a lack of willingness for consumers to pay.

User Willingness to Pay More for 5G

Source: Fitch Ratings, GSMA

GSMA’s “The Mobile Economy 2020” report concluded that the potential of revenue uplift from 5G is greatest in China and South Korea at around 3% growth, followed by the US (2%), but consumer intentions to upgrade to 5G are weaker in Europe, the UK, Japan

Global Telecom Equipment Revenue

Source: Fitch Ratings, Dell’Oro Group

Alternative Network

Trade restrictions on Huawei will create opportunities for technology companies such as Japan’s NEC and South Korea’s Samsung Electronics Co., Ltd. (AA-/Stable). Samsung, which recently clinched a deal with Verizon to supply 5G equipment, is aiming to increase its market share to 20% by end-2020. Research firm Dell’Oro Group estimated that Samsung had a 3% share of the global telecom equipment market in 2019. NEC is the supplier of 4G and 5G networks for Japan’s fourth mobile operator, Rakuten. Huawei and Nordic firms Ericsson and Nokia collectively account for more than half of the world’s telecom equipment revenue, and control a majority of the RAN market.
and Australia. Europe is likely to be more content with 4G speeds, and weak economic conditions there may curb consumer spending.

Telcos have sought to maintain 5G tariffs at current 4G prices to drive subscriber migration at its infancy, although 5G price plans typically fall at the higher end of the range of unlimited plans. None of the US operators are charging extra for their 5G plans. Verizon Communications Inc. (A-/Stable) back-tracked on previous plans to charge additional USD10 monthly for its 5G unlimited plans.

Verizon’s high-band millimetre wave frequencies offer faster 5G speed, but lack coverage. T-Mobile US, Inc. (TMUS, BB+/Stable) was the first in the US to offer nationwide 5G rollout in December 2019, and AT&T, Inc. (A-/Stable) launched its services in July 2020, using their respective low-band 600MHz and 850MHz frequencies. Verizon is targeting nationwide 5G by the end of this year through dynamic spectrum sharing, allowing the use of existing 4G spectrum to support 5G data traffic via a network software upgrade, as opposed to the conventional spectrum re-farming process.

South Korea is one of the few exceptions thus far: telcos found some success in luring subscribers to migrate to higher-priced 5G tariff plans. The Korean 5G user base swelled to 7 million by end-May 2020, representing 10% of its total mobile connections, just over one year after its commercial launch in April 2019.

Korea’s 5G proliferation was driven by generous 5G handset subsidies and the popularity of unlimited data plans bundled with music streaming and media content services, while the government had pushed for sufficient spectrum in the mid-band (3.5GHz) and millimetre wave (28GHz) as early as July 2018. Domestic telcos are also developing adjacent businesses to fuel growth, including content creation, 5G-based cloud gaming, and augmented reality. Carriers have managed to reverse declines in wireless revenue since 2019. However, this is not typical of most other telecom markets.

Korean Telcos’ Wireless Revenue Growth

SK Telecom Co., Ltd (SKT, A-/Negative), KT Corporation (A/Stable) and LG Uplus announced plans to invest up to KRW25.7 trillion (USD22.2 billion) by 2022 to bolster the nationwide 5G network, consistent with South Korea’s five-year Digital New Deal initiatives. The aim is to expand 5G coverage to 70% by 2025. To support the 5G buildout, the Korean government is looking into providing tax incentives, although the specifics have yet to be revealed.

Elsewhere, a few are testing 5G pricing strategy by introducing incremental fees and charging 5G based on speed. For example, BT Group plc’s (BBB/Stable) mobile subsidiary, EE, opted for a premium pricing strategy by bundling plans with value-added services and options to swap content, roaming pass, and top-up data allowances.

Australian market leader Telstra Corporation is seeking to raise monthly prices by at least AUD5 across 5G post-paid plans after September 2020. However, 5G availability is still limited in Australia, and it remains to be seen if Telstra’s peers will follow with a premium pricing strategy. The newly merged TPG-Vodafone Hutchison Australia (now known as TPG Corporation) said it will prioritise network performance instead to drive 5G adoption. The profitability of Australian telcos has been under pressure due to the migration of fixed-broadband users on to NBN Co.’s network.

True 5G Potential Lies in Enterprise Market

Fitch believes the ‘enterprise’ market holds the greatest promise for 5G, as the willingness to invest for efficiency, latency (response time) and reliability can provide new revenue streams for operators, beyond enhanced mobility. However, the real benefits can only be realised with the deployment of a 5G standalone network, along with government initiatives to drive uptake.

Early 5G deployments have so far been based on non-standalone specifications, which are supported by existing 4G radio-access network and core infrastructure, used primarily for enhanced mobile broadband to provide higher data bandwidth. Manufacturing is one of the enterprise verticals to shape the prospects of 5G use cases through smart factories and supply-chain management. ABI Research predicts that manufacturing will represent almost 25% of the total generated revenue in the 5G ultra-low latency use cases market by 2028.

Development of 5G Standalone Networks

Singapore
Singapore’s push for 5G standalone networks is a departure from the strategies of early adopters. The country awarded nationwide 5G licences to Singtel and consortium M1-StarHub in April 2020, setting a 50% nationwide coverage milestone by end-2022. The telcos regulator is partnering with the industry to develop use cases, establishing testbeds and R&D.

UK
Vodafone UK is working with Ericsson, MediaTek, Oppo and Qualcomm on the development of its standalone 5G network, although it is uncertain when the network will be available.

Australia
Telstra has upgraded its 5G RAN coverage across Australia, connecting a Cloud Native 5G Core network to handle 5G standalone traffic, independent of existing 4G network technology.

Korea
All three Korean telcos SKT, KT and LG Uplus have carried out 5G standalone network trials, and aim to launch this technology in 2H20. They agreed to invest a total of KRW2.6 trillion through 2022 to boost 5G network across the country.

US
T-Mobile is planning to deploy a 5G standalone network ahead of its rivals. Up until now, all 5G networks have been in NSA (non-standalone) mode, which mixes 5G radio connections with 4G core networks. 5G standalone-based networks, however, can offer a 40% improvement in latency (or lag time).

Narrowing Rating Headroom

Fitch expects a stable rating trajectory for most of the companies in our global telecom portfolio. However, rating headroom is narrowing amid ongoing competitive pressures on EBITDA, high capex investments, and spectrum auctions. The APAC region has the highest percentage of negative outlooks at 33% (global average: 18%), of which nearly half have close links with parents or are support-upgrade driven.

Our global telecoms portfolio also reflects a widely distributed spectrum of ratings, underscoring the large variation of credit quality within the sector. Fitch’s global telecoms universe (excluding tower companies) has a relatively equal split between high-yield and investment grade. The former is typically highly leveraged, although several publicly rated IDRs in LATAM and EMEA are constrained by Country Ceilings or sovereign risk.

Higher-than-expected 5G investments, the difficulty in forecasting spending in spectrum auctions, and a slower return-on-investments could weigh on leverage metrics, raising the pressure on ratings. GSMA forecasts some 78% of telcos’ USD1.1 trillion mobile investments in 2020-2025 (2019: USD1.0 trillion) will be spent on 5G networks.

Rating pressure is more pronounced in the APAC region. Around two-thirds of the 18 companies have low rating headroom, demonstrating a more limited organic deleveraging capacity relative to the other regions. However, Fitch-rated APAC telcos – unlike their regional peers – are largely investment-grade (89%), reflecting the strong underlying strength and, in some cases, the influence on the ratings from higher-rated parents.

In APAC, we look for sufficient improvements in the operating metrics of South Korea’s largest mobile operator SKT, and indications of 5G investments for Singapore Telecommunications Limited’s (Singtel, A/Stable) standalone network.

In North America, issuers at the lower end of the rating spectrum are typically highly leveraged; they face growing secular challenges – such as the wireline segment – and limitations on their access to capital, which may put further pressure on their ratings in 2021.

Issuers with low rating headroom accounted for 42% of the North American telecom portfolio. Verizon, AT&T and TMUS are committed to 5G rollout over the next few years, while the fourth-largest mobile operator, United States Cellular Corp. (BB+/Stable), should continue to build on its millimetre wave spectrum inventory and acquire more spectrum in the mid-band category in the upcoming auctions.

Some 61% of the 41 companies that we rate in EMEA were in the high-yield category, but the portfolio has 85% on stable outlook and two-thirds with moderate-to-high rating headroom. Deleveraging prospects are constrained by subdued EBITDA growth, fibre broadband deployment, mobile network expansion, and spectrum investments over the next two years. We expect an increase in network sharing – either the passive tower infrastructure or active radio equipment – to reduce the cost of 5G network rollout.

The Latin America portfolio continues to be weighted slightly towards high-yield issuers, at 63% of the 19 publicly rated IDRs. Rating constraints include Country Ceilings, weakening macroeconomic fundamentals, and Fitch’s expectations of shareholder distributions.

Our expectations that the region will remain a 5G laggard underscores a lower capex risk, although the large forex exposure and sovereign risks will continue to drive its rating trajectory.
Global Telecom: Key Assumptions

<table>
<thead>
<tr>
<th>Region</th>
<th>Key assumptions</th>
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</table>
| APAC     | • Average revenue growth to be flat to low-single-digit in 2020 (2019: 4%), before recovering to pre-pandemic levels in 2021.  
• Upselling of data services and bundles to increase average revenue per user (ARPU) and accelerate cost-cutting efforts to manage EBITDA margins.  
• Advanced 5G markets such as South Korea, China, Japan, Taiwan, Singapore and Australia to position 5G as network differentiator to stem competition. Telstra’s tariff hike on 5G plans will serve as a reference for monetisation prospects outside South Korea.  
• Emerging markets, including India, Indonesia, Thailand and the Philippines, are likely to delay discretionary capex to enable investments to meet proven demand. High exposure to Chinese telecom equipment could contribute to 5G procurement uncertainties. Capex intensity in these markets is likely to stay at around 25%-40%, above the region’s average in the low 20s. |
| North America | • Relatively stable telecoms revenue due to the essential nature of wireless and broadband services, although the pandemic impact is more pronounced on media assets and advertising revenue. We had previously anticipated low-single digit revenue growth with margin improvement, but these setbacks are likely to dent prospects.  
• The pandemic is unlikely to slow the pace of 5G rollout in the US, and will have a limited effect on AT&T’s and Verizon’s pre-dividend FCF. We expect 5G deployment to ramp up in 2H20 and 2021, as more spectrum becomes available. However, higher 5G spending is unlikely to affect overall capex, with receding 4G investments. We forecast median capex/revenue of 16%.  
• No change in dividend policies, as we believe dividend cuts would be the last option. Wireless leaders Verizon and AT&T, and cable operators, have sufficient financial resilience and opex levers to support a continuation of planned 5G capex, without cutting dividends.  
• Following its acquisition of Sprint Corporation in April 2020, TMUS has greater resources to aggressively invest and deploy Sprint’s mid-band spectrum that supports a more robust nationwide 5G network build-out, with greater capacity that meets regulatory requirements for population coverage and speed. |
| EMEA    | • Median decline in revenue of 4%-6%, and EBITDA margins to narrow by 3%-5% in 2020.  
• Companies could cut capex by 15%-30% in 2020 to mitigate cash burn caused by the economic fallout of the coronavirus pandemic. Capex in the sector is usually at least 60%-denominated in hard currency, making it costlier to invest when local currencies depreciate.  
• Spectrum auctions and 5G pilot projects to be postponed until 2021; the region is viewed as a 5G laggard, and will continue to focus on transition from 3G to 4G in 2020-2021.  
• Non-core assets divestment throughout the region to improve financial flexibility and deleveraging.  
• Net leverage should trend sideways around 3.0x for the portfolio as a whole. Investment grade issuers generally have around 1.0x less net debt than their non-investment-grade counterparts. However, the leverage metric is not the most important rating driver for certain non-investment-grade issuers that are constrained by Country Ceilings. |

Source: Fitch Ratings
Global Telecoms: Distribution of IDRs
As of end-August 2020
(Number of issuers)

Note: Public Foreign-Currency IDRs only and excludes tower companies. Source: Fitch Ratings

Global Telecoms Rating Outlook/Watch
As of end-August 2020

Note: Public Foreign-Currency IDRs only and excludes tower companies. Source: Fitch Ratings

Investment Grade Vs. High Yield Portfolio
As of end-August 2020

Note: Public Foreign-Currency IDRs only and excludes tower companies. Source: Fitch Ratings

Global Telecoms: Rating Upgrades and Downgrades
January-August 2020
(No.)

Note: Public Foreign-Currency IDRs only and excludes tower companies. Source: Fitch Ratings

5G Vs. 4G Download Speeds
(Average download speed (Mbps))

Data collection from 16 May to 14 August 2020
Source: Fitch Ratings, Opensignal
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