Rule of 40

Metric Standards Document

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Metric Name: Rule of 40

Alternative Metric Name(s): N/A

Rule of 40 Overview

Definition: Rule of 40

The **"Rule of 40"** measures the top-line Growth Rate plus the profitability of the business. The Rule of 40 is intended to capture a combined view of performance, including growth and profitability in a single, compound metric.

While there are a variety of measures for growth and profitability that have been used for the Rule of 40, the SaaS Metrics Standards Board recommends using the annual growth rate in ARR as the measure of growth and the Free Cash Flow (FCF) Margin for the measure of profitability. FCF is defined as Cash from Operations minus Capital Expenditures.

Business Value and Insights: Rule of 40

The Rule of 40 metric provides a blended, multivariate view of SaaS business performance, weighting growth and profitability equally. The term "Rule of 40" was originally coined in 2015 by venture capitalists Brad Feld and Fred Wilson, referring to their view that venture-backed companies should strive to achieve 40% or greater when combining growth rate plus profitability margin. Over the years, Rule of 40 has become a popular metric, with multiple calculation variations on which measures of growth and profitability to use (see below).

Rule of 40 is a convenient way to determine if a SaaS company is balancing the growth rate and the cost of achieving that growth rate. Historically, companies with a Rule of 40 equal to or greater than 40% will experience high enterprise value multiples to revenue.

Rule of 40 Formula(s)

Calculation Formula #1: Rule of 40 - using Annual Recurring Revenue (ARR)

Annual ARR Growth Rate + Annual Free Cash Flow Margin[1]

[1] Free Cash Flow Margin as a percentage is calculated by using Cash from Operations minus Capital Expenditures, divided by Average ARR in the period

Data Inputs Required: *Rule of Calculation Formula #1: ARR*

Data Input #1: ARR at beginning of Accounting Period
Data Input #2: ARR at end of Accounting Period
Data Input #3: Free Cash Flow Percentage

Data input #1 and #2 is typically available in the subscription billing platform, contract management platform or CRM platform

Data input #3 information is typically available from Free Cash Flow statement or on GAAP Financial Statements

Calculation Formula #2: Rule of 40 - using GAAP Revenue

Annual Growth Rate in GAAP Revenue + Annual Free Cash Flow Margin

Data Inputs Required: *Rule of Calculation Formula #2: GAAP Revenue*

Data Input #1: GAAP Revenue at beginning of Accounting Period
Data Input #2:GAAP at end of Accounting Period
Data Input #3: Free Cash Flow Percentage

Data input #1 and #2 is typically available in the subscription billing platform, contract management platform or CRM platform

Data input #3 information is typically available from Free Cash Flow statement or on the GAAP Financial Statements

Recommended Calculation Timing: Rule of 40

Rule of 40 should be calculated at least annually in alignment with the fiscal year, and calculating quarterly to see trending is recommended.

Rule of 40 Calculation Examples

Sample Calculation #1: GAAP Revenue and Free Cash Flow

List of Input Values:

GAAP Revenue (2021) = $30,000,000
GAAP Revenue (2022) = $38,000,000

Free Cash Flow (2022) = $8,000,000

Calculation Formula:

$$\frac{(\$38{,}000{,}000 - \$30{,}000{,}000)}{\$30{,}000{,}000} + \frac{\$8{,}000{,}000}{\$38{,}000{,}000} = 27\% + 21\% = 48\% \text{ Rule of 40}$$

Sample Calculation #2: GAAP Revenue and EBITDA

List of Input Values:

GAAP Revenue (2021) = $30,000,000
GAAP Revenue (2022) = $38,000,000

EBITDA (2022) = $2,000,000

Calculation Formula:

$$\frac{(\$38{,}000{,}000 - \$30{,}000{,}000)}{\$30{,}000{,}000} + \frac{\$2{,}000{,}000}{\$38{,}000{,}000} = 27\% + 8\% = 35\% \text{ Rule of 40}$$

Rule of 40 Considerations and Nuance

#1: Annual Recurring Revenue or GAAP Revenue

Annual Recurring Revenue is the default variable used to calculate growth rate in the Rule of 40. However, since most public companies only report GAAP revenue and thus calculate the Rule of 40 using GAAP revenue, calculating the Rule of 40 using both ARR and GAAP revenue is a good practice to benchmark against public companies.

#2: Free Cash Flow versus EBITDA

EBITDA is the most commonly used variable for private SaaS companies and Free Cash Flow is primarily used by public companies. Whichever profitability measurement is used, ensure you disclose the model you are using to all current and potential investors, and be considered when comparing internally calculated Rule of 40 versus external benchmarks.

Rule of 40 - Links to related Standards

Annual Recurring Revenue: Standards Document