MERLIN LABS UPDATE

The ‘new kid on the block’ in the Codex portfolio is off to a solid start it appears. After we took a position at $6 recently and I finished that 11 page extensive analysis on the company, the price action was solid, but very volatile, as one may expect with a post-SPAC AI play. Then came yesterday's news and as I am writing this, the stock is up 30% on after-hours trading and up ~60% since the first buy alert. To say that is remarkable would be an understatement, so let's have a closer look at is driving this and what it means for the company going forward. If you have not yet read through that aforementioned extensive analysis piece, please take some time to do so, as it will provide a lot of important context for this company. For now though, the news.

Merlin announced the successful completion of the critical design review for its C-130J autonomy program with USSOCOM. For those who read the original piece, this was one of the catalyst I identified as an incredibly important gate between where Merlin was and where it needs to go. Well, it just passed and as you can see from the share price, the market likes it. In the lifecycle of a military technology program, the CDR is the point where the government takes a hard look at the final system architecture and decides whether the design is mature enough to proceed into physical hardware integration and testing. Basically it is what happens when a company with a fancy Powerpoint presentation and an early stage technology, of which there are many, becomes a company that actually makes it ‘into the field’, of which there are few on a relative basis. The review process involves a rigorous audit of the system design down to specific component interfaces, software architecture, fault handling, safety mechanisms, integration plans and I could go on and on. The government's engineers and program managers go through the design package and verify that what has been proposed on paper can actually be built, tested, and eventually fielded. When CDR passes, the program transitions from "can this be designed?" to "build it and prove it works." Welcome to that second phase ladies and gentlemen, I hope you enjoy your stay.

For Merlin specifically, passing CDR means USSOCOM has formally reviewed and approved the architecture of the Merlin Pilot autonomy stack as it will be integrated onto the C-130J Super Hercules (Merlin and Hercules, we are pulling out all the mythical tales now, how can that not be bullish). The program now moves into aircraft integration activities and a structured formal test campaign that includes ground-level and aircraft-level verification. George said in the press release that this "validates the architecture we've built for safe, scalable autonomy on large aircraft like the C-130J" and that the company is now focused on "proving autonomy from takeoff to touchdown is one of the most effective ways to improve operations and safety for US warfighters." In the deep dive, I was explicit about the fact that even my bear case required Merlin to clear hurdles it had not yet cleared, because the ‘true bear case’ is simply that this thing goes to $0, no ifs, buts are maybes. CDR was the first and arguably most important of those hurdles, because it is the gate between a design concept and a physical program. Before CDR, there was a legitimate question about whether USSOCOM would look at Merlin's proposed architecture and tell them to go back to the drawing board, or whether the design was too ambitious for the certification and safety requirements of a four-engine military transport. That question has now been answered, and the answer was yes, the design is sound, proceed to integration. What remains is execution. Integration, ground testing, and flight demonstration are all still ahead as you can imagine, but those are engineering and manufacturing challenges, not architectural ones. The "can this work?" question is now "how well and how fast does this work?" and “will we use it at scale?”. Programs can still fail after CDR, I want to make that clear, but the failure mode shifts and market price action is startign to reflect that as well on the back of this news.

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From a contract perspective, passing CDR protects the existing task orders under the $105 million IDIQ ceiling and unlocks the next phases of work, which means revenue from the C-130J program should begin to accelerate in the second half of 2026 and into 2027 if I recall correctly. The Q1 revenue of $1 million was always going to be light because the program was in the design phase and we are not invested in this company for any revenue it is coming up with today. Now that it has moved into integration and testing, the task order flow should pick up. As a reminder, on June 3, one day before the CDR announcement, TD Cowen initiated coverage of MRLN with a buy rating and an $11 price target, representing roughly 45% upside from the pre-announcement close.

For those who recall, I flagged TD Cowen as the most likely next analyst initiator in the deep dive, noting their role as co-placement agent on the $80 million PIPE. Well, they are here and Merlin now has two sell-side analysts covering the stock (Roth at Buy/$15, TD Cowen at Buy/$11) and the consensus price target of $13 is a good start. If Merlin continues to deliver, I expect those price targets to be moved up, as is tradition with these price reporters. The institutional discovery phase that I said had not begun could now be underway in a meaningful way. TD Cowen noted in their initiation that Merlin's contracts on the C-130J and KC-135 programs form the foundation of the thesis, and cautioned that EBITDA and free cash flow will remain negative for years with high volatility expected. I know that sounds negative, but honestly that is the right framing I think. This is not a stock you buy for next quarter's earnings. It is a stock you buy for where the market will be pricing where the program will be in 2028 and beyond. That 'view on the future' just got a lot more positive with this news release, but there is a long road ahead for the company and they will need to keep delivering to get anywhere close to the bull case model I laid out in the analysis piece.

Having said that, if we want to focus on potential near term price action, we can do that for a moment. While I have never been a fan of the 'short squeeze will send this to the moon' crowd, I will note that short interest on MRLN has been climbing steadily and hit all-time highs heading into the CDR announcement. From data that I saw, it shows short interest rising from 3.1 million shares on May 21 to 4.6 million shares on June 3, with borrow rates running at 36-38%. On a stock with a relatively thin public float, 4.6 million shares short represents a substantial portion of the freely tradeable supply and comes in at 3x daily average trading volume going just to this short position in order to cover it, at least on paper. The 30-40%+ after-hours move on the CDR news puts a notable portion of those shorts underwater, although I can't say how much exactly of course, and the high borrow rate tells you the shorts were already paying a premium to maintain their positions before the news hit. I am not going to predict a short squeeze because that kind of thing depends on flows and positioning that I cannot see from the outside, but I will note that the mechanical setup is about as favorable as it gets for the long side. A genuine fundamental catalyst in the form of CDR completion landing on top of major short interest with a 37% borrow rate on a stock with minimal float is the kind of combination that produces violent near term moves, like the one we saw in April when the stock moved up a massive 155% in the span of just a week. Whether the after-hours price holds or gets pushed higher when regular trading opens remains to be seen, as I will be out to do volunteering work late afternoon into this evening, so I will be eagerly awaiting to see how it will have closed when I get back. Whatever near term price action may (or may not) bring though, this is a meaningful catalyst for the company.

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To note, the CDR completion does not change my price targets. The bear case of $16, the base case of $77, and the bull case of $216 were all built on the assumption that Merlin would eventually clear CDR and proceed to integration, otherwise the real bear case was and will always be exactly $0. What changes is the probability weighting. Before CDR, I had a meaningful probability assigned to the scenario where the design review failed or was significantly delayed, which compressed the expected value. With CDR now passed, that risk has dropped meaningfully and the probability distribution shifts toward the base and bull cases. If I had to re-weight today, I would move from 35% bear / 45% base / 20% bull to something closer to 25% bear / 50% base / 25% bull. Not all out fully-derisked bull mode yet, but a good step in the right direction.

Alright, so what now? The sequence from here is integration, ground testing, and flight demonstration. George said on the Q1 earnings call that the C-130J program will be "the first time autonomy flies on an operational Air Force aircraft." That moment, when the Merlin Pilot actually flies a C-130J from takeoff to touchdown, will be the next major catalyst and will likely be the event that likely forces a broader market re-rating. In the March Aviation Week interview around the PDR completion, CTO Timothy Burns told the reporter that CDR was expected within the next few months and that first flight was targeted for later this year, meaning later in 2026. Now, whether that late 2026 target still holds after CDR landing yesterday is a fair question. Integration, ground testing and flight demonstration all have to happen between now and year-end for that timeline to work, which is tight and defense timelines are notoriously elastic and could slip of course. In the nearer term, Q2 results and other updates over the coming few months should show whether CDR completion is translating into accelerated task order flow. Additionally, the three investor conferences Merlin has scheduled for June (Jefferies Defense Tech Summit yesterday, Roth's London Conference June 16-18, and Maxim's Defense Tech Conference June 25) have two happen with CDR as a confirmed talking point rather than a pending risk, which does change the tenor of every management chat with institutional capital.

That about covers the news and my thoughts on it. I hope that the update proves to be informative and that the price action is treating you all well. Thanks for tuning in and have a good and healthy weekend, cheers! ~Mart

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