Modern Water plc
Interim Financial Report 2008

MODERNWATER

Our highlights

- Desalination proving plant in Gibraltar; in final stages of commissioning
- Office opened in Oman to tap into the Middle Eastern market
- Additional interest from the Mediterranean and Asia
- Stake in Cymtox increased to 53%
- Strong cash position with £28.7 million in hand at 30 June 2008

Report to shareholders

"With our portfolio of pioneering technologies, a robust balance sheet and a strong team, the board looks forward to both the immediate and long-term future with confidence."

It is with great pleasure that I make my second interim report as Executive Chairman of Modern Water plc. The company has made good progress in the first half of 2008.

In line with our strategy, we are rapidly moving to the commercial roll-out of our ground breaking technologies. Our manipulated osmosis desalination plant, the first of its kind in the world to be developed, was completed at the end of July and is now in the final stages of commissioning in Gibraltar. We anticipate that the plant will prove how our technology delivers a higher output whilst using less energy and keeping capital and operational costs down. In due course, this new technology will provide a cheaper and more environmentally friendly alternative to a growing, multi-billion dollar desalination marketplace.

The company increased its stake in Cymtox to 53% in April 2008. This is consistent with our ambition to expand the Modern Water investment portfolio and will enable us to further influence the unique water quality protection and toxicity monitoring technology being developed by Cymtox.

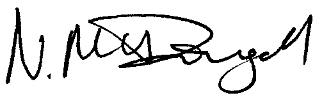
Our team continues to grow, and I am delighted to welcome the new staff to Modern Water. We are carefully targeting our international expansion and growth, with an office located in the UK, as well as a newly opened office in Oman to tap into the large and fast-growing Middle Eastern market.

Modern Water is focusing on specific key markets as we expand our international operations. The Middle East, Mediterranean region and Asia have great potential and we are pleased to have received interest in our technologies from these territories.

Our growing portfolio of leading edge water-related technologies offers a number of significant potential near-term revenue streams. These include a wastewater treatment product which reduces domestic fresh water requirement by over 30%; pre-treatment technology that increases thermal desalination output by up to 25% and extends plant lifespan; and a technology that uses the manipulated osmosis process in cooling towers to reduce environmental damage and costs.

In difficult economic times, we continue to marshal our financial resources carefully. As a result, we remain in a robust financial position with a strong balance sheet. At 30 June 2008, we had £28.7m cash which is equivalent to 49 pence/share.

With our portfolio of pioneering technologies, a robust balance sheet and a strong team, the board looks forward to both the immediate and long-term future with confidence.



Neil McDougall
Executive Chairman
9 September 2008

Balance sheet

	Note	**30 June 2008 £'000**	30 June 2007 £'000	31 December 2007 £'000
Assets				
Non-current assets				
Property, plant and equipment	6	**506**	15	409
Intangible assets	6	**14,176**	13,647	13,772
Investments	6	**90**	75	257
Total non-current assets		**14,772**	13,737	14,438
Current assets				
Trade and other receivables		**357**	101	688
Cash and cash equivalents		**28,719**	30,484	29,059
Total current assets		**29,076**	30,585	29,747
Total assets		**43,848**	44,322	44,185
Equity and liabilities				
Equity				
Share capital		**147**	147	147
Share premium account		**30,532**	30,548	30,532
Merger reserve		**12,782**	12,782	12,782
Retained earnings		**(1,124)**	(298)	(380)
		42,337	43,179	43,081
Minority interest		**174**	229	173
Total equity		**42,511**	43,408	43,254
Non-current liabilities				
Deferred income tax liabilities	5	**433**	440	427
Total non-current liabilities		**433**	440	427
Current liabilities				
Trade and other payables		**879**	453	472
Borrowings		**25**	21	32
Total current liabilities		**904**	474	504
Total liabilities		**1,337**	914	931
Total equity and liabilities		**43,848**	44,322	44,185

The notes on pages 7 to 11 form an integral part of this condensed consolidated interim financial information.

Income statement

	Note	**6 months ended 30 June 2008 £'000**	9 months ended 30 June 2007 £'000	15 months ended 31 December 2007 £'000
Operating expenses	4	**(1,962)**	(1,112)	(2,719)
Operating loss		**(1,962)**	(1,112)	(2,719)
Finance income		**849**	115	1,020
Share of (post tax) losses of associates		**(35)**	(68)	(50)
Loss before income tax		**(1,148)**	(1,065)	(1,749)
Income tax credit	5	**13**	3	16
Loss for the period		**(1,135)**	(1,062)	(1,733)
Attributable to:				
– equity shareholders of the company		**(1,046)**	(1,015)	(1,632)
– minority interest		**(89)**	(47)	(101)
		(1,135)	(1,062)	(1,733)

All results derive from continuing operations.

	6 months ended 30 June 2008	9 months ended 30 June 2008	15 months ended 31 December 2007
Loss per share attributable to the equity holders of the company			
– basic	**1.8p**	5.4p	4.6p
– diluted	**1.7p**	5.3p	4.5p

The notes on pages 7 to 11 form an integral part of this condensed consolidated interim financial information.

Statement of changes in equity

	Called up share capital £'000	Share premium account £'000	Merger reserve £'000	Retained earnings £'000	Minority interest £'000	Total equity £'000
Balance at 11 October 2006	—	—	—	—	—	—
Loss for the period	—	—	—	(1,015)	(47)	(1,062)
Total recognised income for the period	—	—	—	(1,015)	(47)	(1,062)
Proceeds of share issues	120	30,548	—	—	—	30,668
Share for share exchange	27	—	12,782	—	—	12,809
Share based payment schemes	—	—	—	717	—	717
Minority interest at acquisition	—	—	—	—	276	276
Balance at 30 June 2007	147	30,548	12,782	(298)	229	43,408

	Called up share capital £'000	Share premium account £'000	Merger reserve £'000	Retained earnings £'000	Minority interest £'000	Total equity £'000
Balance at 1 January 2008	147	30,532	12,782	(380)	173	43,254
Loss for the period	—	—	—	(1,046)	(89)	(1,135)
Minority interest at acquisition	—	—	—	—	90	90
Share based payment schemes (note 7)	—	—	—	302	—	302
Balance at 30 June 2008	**147**	**30,532**	**12,782**	**(1,124)**	**174**	**42,511**

The notes on pages 7 to 11 form an integral part of this condensed consolidated interim financial information.

Cash flow statement

	Note	**6 months ended 30 June 2008 £'000**	9 months ended 30 June 2007 £'000	15 months ended 31 December 2007 £'000
Cash flows from operating activities				
Cash used in operations	4	**(1,215)**	(265)	(1,270)
Net cash flows used in operating activities		**(1,215)**	(265)	(1,270)
Cash flows from investing activities				
Purchases of property, plant and equipment	6	**(138)**	(10)	(433)
Purchase of patents and development costs	6	**(111)**	—	(163)
Acquisition of subsidiaries, net of cash acquired	3	**66**	(110)	(110)
Acquisition of associates		**—**	(75)	(167)
Acquisition of other investments		**—**	—	(90)
Net cash flows from investing activities		**(183)**	(195)	(963)
Cash flows from financing activities				
Proceeds from issue of ordinary shares		**—**	32,253	32,253
Transaction costs of issuing shares		**—**	(1,305)	(1,601)
Proceeds of borrowing		**—**	—	15
Repayments of borrowings		**(5)**	(4)	(8)
Interest received		**1,063**	—	633
Net cash flows from financing activities		**1,058**	30,944	31,292
Net (decrease)/increase in cash and cash equivalents		**(340)**	30,484	29,059
Cash and cash equivalents less bank overdraft at start of period		**29,059**	—	—
Cash and cash equivalents and bank overdrafts at end of period		**28,719**	30,484	29,059

The notes on pages 7 to 11 form an integral part of this condensed consolidated interim financial information.

Notes
to the condensed consolidated interim financial information

1 General information

Modern Water plc ('the company') and its subsidiaries (together, 'the group') invests in, develops and deploys new water technology.

The company is a limited liability company incorporated and domiciled in the UK. The address of its registered office is Bramley House, The Guildway, Old Portsmouth Road, Guildford GU3 1LR.

The company is quoted on the AIM market of London Stock Exchange.

This condensed consolidated interim financial information was approved for issue on 9 September 2008.

These interim financial results do not comprise statutory accounts within the meaning of Section 240 of the Companies Act 1985. Statutory accounts for the 15 month period ended 31 December 2007 were approved by the board of directors on 29 February 2008 and delivered to the Registrar of Companies. The report of the auditors on those accounts was unqualified, did not contain an emphasis of matter paragraph and did not contain any statement under section 237 of the Companies Act 1985 (section 498 of the Companies Act 2006).

This condensed consolidated interim financial information has been reviewed, not audited.

2 Basis of preparation and accounting policies

The principal accounting policies have been applied consistently throughout the period in the preparation of these financial statements.

(a) Basis of preparation

This condensed consolidated interim financial information for the six months ended 30 June 2008 has been prepared in accordance with the AIM Rules for Companies of the London Stock Exchange plc and with IAS 34, 'Interim financial reporting' as adopted by the European Union.

Except as described below, the accounting policies applied are consistent with those of the annual financial statements for the year ended 31 December 2007.

Taxes on income in the interim periods are accrued using the tax rate that would be applicable to expected total annual earnings.

IFRS 7 'Financial instruments' is effective for the year ended 31 December 2008 and will result in changes of disclosures regarding financial instruments and associated notes in the annual financial statements.

(b) Standards not yet effective

The following pronouncements have been issued since approval of the 2007 financial statements but are not effective for the year ended 31 December 2008:

On 22 May 2008, the IASB issued an amendment to IFRS 1 'First time adoption of IFRS' and IAS 27 'Consolidated and separate financial statements' effective for annual periods beginning on or after 1 January 2009. There is no expected impact on the group.

On 8 May 2008, IFRIC approved an Interpretation based on D22, 'Hedges of a net investment in a foreign operation' requiring that in a net investment hedge, the currency risk being hedged must be between the functional currency of the foreign operation and that of any of its parent entities (ultimate or intermediate parent). There is no expected impact on the group.

Notes
to the condensed consolidated interim financial information continued

3 Business combinations

At 1 January 2008 the group owned 37% of the share capital of Cymtox Limited ('Cymtox'), which had been accounted for as an associate company. On 14 April 2008 Cymtox issued ordinary shares which the group acquired for a cash consideration of £150,000, taking the group holding to a controlling interest of 53%.

The acquired business contributed revenues of £nil and net costs of £56,000 to the group for the period from acquisition to 30 June 2008. If the acquisition had occurred on 1 January 2008, Cymtox would have contributed revenue and losses for the period ended 30 June 2008 of £nil and £150,000 respectively.

Details of net assets acquired and goodwill are as follows:

	As at 31 December 2007 £'000	6 months ended 30 June 2008 £'000	Total £'000
Cash consideration	167	150	317
Fair value of net identifiable assets acquired	(19)	(14)	(33)
Goodwill	**148**	**136**	**284**

The goodwill is attributable to the potential of Cymtox' in its markets and the synergies expected to arise after acquisition by the group.

The assets and liabilities arising from the acquisition are as follows:

	As at 31 December 2007		**6 months ended 30 June 2008**	
	Acquiree's carrying amount £'000	Fair value £'000	**Acquiree's carrying amount £'000**	**Fair value £'000**
Cash and cash equivalents	63	63	**216**	**216**
Intangibles	—	70	**—**	**68**
Development costs	—	—	**17**	**17**
Payables	(61)	(61)	**(195)**	**(195)**
Deferred tax liability	—	(20)	**—**	**(19)**
Net identifiable assets	2	52	**39**	**87**
Percentage acquired		37%		**16%**
Net identifiable assets acquired		19		**14**

Outflow of cash to acquire business, net of cash acquired:	
– cash and cash equivalents in subsidiary acquired	**216**
– cash consideration	**(150)**
Cash inflow on acquisition	**66**

4 Operating expenses

The following items have been charged to operating expenses during the interim period:

	6 months ended 30 June 2008 £'000	9 months ended 30 June 2007 £'000	15 months ended 31 December 2007 £'000
Fair value of employee share based remuneration (note 7)	**302**	477	820
Other share based payments for services from IP Group plc	**—**	240	432
Wages and salaries	**888**	130	469
Social security costs	**58**	15	56
Other employee benefits	**39**	—	7
Depreciation of tangible fixed assets	**41**	2	26
Amortisation of intangible assets	**76**	14	70
Minimum lease payments recognised as an operating lease expense	**74**	—	63

IP Group plc is a significant shareholder of the company.

Net cash flows from operating activities

	6 months ended 30 June 2008 £'000	9 months ended 30 June 2007 £'000	15 months ended 31 December 2007 £'000
Operating loss	**(1,962)**	(1,112)	(2,719)
Adjustments for:			
Depreciation of property, plant and equipment	**41**	15	26
Amortisation of intangible assets	**76**	—	73
Equity-settled share-based payments	**302**	717	1,252
Movements in working capital:			
Decrease/(increase) in trade and other receivables	**70**	(42)	(177)
Increase in trade and other payables	**258**	157	275
Cash used in operations	**(1,215)**	(265)	(1,270)

Notes
to the condensed consolidated interim financial information continued

5 Income taxes

During the period there were no taxable profits. At the balance sheet date the group had a deferred tax asset in respect of unutilised trading losses. This asset has not been recognised as its utilisation is not yet sufficiently certain.

The deferred tax liability of £433,000 at 30 June 2008 (2007: £440,000) arises from taxable temporary differences on intangibles recognised on business combinations and is expected to unwind over the useful economic life of these assets. £13,000 has been credited to the Income Statement to 30 June 2008 (2007: £3,000).

6 Capital expenditure

	Property, plant and equipment £'000	Intangible assets £'000	Investments £'000	Total £'000
Opening net book amount at 1 January 2008	409	13,772	257	14,438
Acquisition of subsidiary (note 3)	—	369	(167)	202
Additions	138	111	—	249
Depreciation/amortisation	(41)	(76)	—	(117)
Closing net book amount at 30 June 2008	506	14,176	90	14,772

7 Share based payments

	6 months ended 30 June 2008 £'000	9 months ended 30 June 2007 £'000	15 months ended 31 December 2007 £'000
Option scheme	**170**	473	180
Management share incentive scheme	**63**	4	640
Employee bonus scheme	**69**	—	—
Fair value of employee share based remuneration	**302**	477	820

7 Share based payments continued

Option scheme

The directors' and employees' holdings of options over ordinary shares issued under the Modern Water Incentive Plan were as follows:

				Number of options				
Date of grant	Earliest exercise date	Expiry date	Exercise price	1 January 2008	Granted in period	Exercised in period	Lapsed in period	**30 June 2008**
Neil McDougall*								
12.06.07	12.06.08	12.06.17	119.0p	186,959	—	—	186,959	**—**
12.06.07	12.06.09	12.06.17	119.0p	186,959	—	—	—	**186,959**
12.06.07	12.06.10	12.06.17	119.0p	186,959	—	—	—	**186,959**
Simon Humphrey*								
12.06.07	12.06.08	12.06.17	119.0p	373,917	—	—	373,917	**—**
12.06.07	12.06.09	12.06.17	119.0p	373,918	—	—	—	**373,918**
12.06.07	12.06.10	12.06.17	119.0p	373,918	—	—	—	**373,918**
Employees**								
13.12.07	13.12.10	13.12.19	97.0p	600,000	—	—	—	**600,000**
26.02.08	26.02.11	26.02.20	87.5p	—	200,000	—	—	**200,000**
02.06.08	02.06.11	02.06.20	112.5p	—	200,000	—	—	**200,000**
				2,282,630	400,000	—	560,876	**2,121,754**

* The Modern Water Incentive Plan provides options to directors subject to performance criteria. One third of the options vest on the date 12 months from AIM admission, one third vest on the date 24 months from AIM admission and one third vest on the date 36 months from AIM admission. Each tranche will vest subject to total shareholder return being at least equal to 10% for the 12 months preceding the relevant tranche vesting date.

** Options will vest subject to total shareholder return being at least equal to 30% for the 3 years between grant and vesting.

Management Share Incentive Scheme ('MSIS')

The directors' holdings of ordinary shares issued under the MSIS were as follows:

	Date of subscription	No of Ordinary Shares	Subscription price
Neil McDougall	1.12.06 &12.03.07	3,363,400	0.1p
Simon Humphrey	1.12.06 &12.03.07	1,479,000	0.1p
Gerald Jones	1.12.06	200,000	0.1p

One third of the MSIS shares are not subject to restrictions. One third of the MSIS shares are subject to restrictions which were lifted on 1 December 2007. One third of the MSIS shares are subject to restrictions which are lifted on 1 December 2008.

Independent review report
to Modern Water plc

Introduction
We have been engaged by the company to review the condensed set of financial statements in the half-yearly financial report for the six months ended 30 June 2008, which comprises the balance sheet, income statement, statement of changes in equity, cash flow statement and related notes. We have read the other information contained in the half-yearly financial report and considered whether it contains any apparent misstatements or material inconsistencies with the information in the condensed set of financial statements.

Directors' responsibilities
The half-yearly financial report is the responsibility of, and has been approved by, the directors. The directors are responsible for preparing the half-yearly financial report in accordance with the AIM Rules for Companies which require that the financial information must be presented and prepared in a form consistent with that which will be adopted in the company's annual financial statements.

As disclosed in note 2, the annual financial statements of the group are prepared in accordance with IFRSs as adopted by the European Union. The financial information included in this half-yearly financial report has been prepared in accordance with International Accounting Standard 34, 'Interim Financial Reporting', as adopted by the European Union.

Our responsibility
Our responsibility is to express to the company a conclusion on the condensed set of financial statements in the half-yearly financial report based on our review. This report, including the conclusion, has been prepared for and only for the company for the purpose of the AIM Rules for Companies and for no other purpose. We do not, in producing this report, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Scope of review
We conducted our review in accordance with International Standard on Review Engagements (UK and Ireland) 2410, 'Review of Interim Financial Information Performed by the Independent Auditor of the Entity' issued by the Auditing Practices Board for use in the United Kingdom. A review of interim financial information consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing (UK and Ireland) and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion
Based on our review, nothing has come to our attention that causes us to believe that the condensed set of financial statements in the half-yearly financial report for the six months ended 30 June 2008 is not prepared, in all material respects, in accordance with International Accounting Standard 34 as adopted by the European Union and the AIM Rules for Companies.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Chartered Accountants, Gatwick

9 September 2008

Notes:

(a) The maintenance and integrity of the Modern Water plc website is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.

(b) Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.